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Bestseller!**



Real Estate Economics: Realty Almanac 2022-2024

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Table of Contents

<i>Table of market charts</i>	vii
<i>California's Economic Recovery Timeline</i>	xii

Chapter 1.1	Employment: a prerequisite to renting or owning <i>Income for the necessities of life</i>	1
Chapter 1.2	Jobs move real estate <i>Jobs' impact on real estate</i>	4
Chapter 2.1	Long- and short-term rates <i>Financing for ownership of real estate goes long</i>	7
Chapter 2.2	30 years of summer followed by 30 years of winter <i>Bond market cycles</i>	12
Chapter 2.3	The yield spread foretells recessions and recoveries <i>To know how your market will evolve</i>	17
Chapter 2.4	How to time the market <i>To buy or sell in 2022?</i>	24
Chapter 2.5	Buyer purchasing power determines home prices <i>The driving force of real estate pricing</i>	32
Chapter 2.6	The influence of Federal Reserve policies <i>The discount rate at work</i>	40
Chapter 2.7	Assorted market rates <i>91-day Treasury Bill — Average Auction Rate</i>	46
Chapter 3.1	The great gamble: real estate speculators decoded <i>Why the spectacle?</i>	51
Chapter 3.2	Agreements for the flip of a property <i>When you need to flip, do it right.</i>	58

Factor 1
Jobs

Factor 2
Interest rates

Factor 3
Real estate speculation

Factor 4
Homeownership

Chapter 4.1 Homeownership as a savings plan
Implicit rental income offsets owner's risk of loss 65

Chapter 4.2 Negative equity and foreclosure
A crisis squandered by an inactive government 69

Chapter 4.3 A balance sheet reality check
Underwater property: the family's black-hole asset 73

Factor 5
Home sale volumes

Chapter 5.1 Home sales volume and price peaks
A long recovery for sales volume..... 79

Factor 6
Renting: the alternative to homeownership

Chapter 6.1 Rent: the requisite to property value
Rent determines a property's fair market value 85

Chapter 6.2 Renting and owning across counties
Are rentals the future of California real estate? 90

Chapter 6.3 Renting versus buying: the GRM as a measure
A comparison of expenditures to rent or own an SFR 97

Factor 7
Mortgages

Chapter 7.1 The ARM vs. the FRM
The real estate mortgage 107

Chapter 7.2 A lesson from the housing bubble
Securitization and subprime lending 113

Chapter 7.3 Preventing the next real estate bubble
Harness market momentum excitement..... 117

Factor 8
Inflation & CPI

Chapter 8.1 Back to basics: inflation 101
Fluctuation in the price level of goods and services 125

Chapter 8.2 Beyond the basics:
asset price inflation in the real estate market
Asset inflation: where does real estate fit in?..... 131

Factor 9
Savings

Chapter 9.1 The 20% solution:
personal savings and homeownership
Mortgages: QRM versus QM..... 139

Chapter 9.2 Income inequality harms California's housing market
California's household demographics..... 146

Chapter 10.1	Single family residential (SFR) and multi-family construction <i>The trend in California construction starts</i>	153
Chapter 10.2	Blueprints for future construction <i>The need for government action</i>	159
Chapter 11.1	California's vacant residential properties <i>More housing than people, but diminishing</i>	167
Chapter 12.1	California tiered home pricing <i>Price tier fluctuations</i>	175
Chapter 12.2	A realty black hole <i>Belief in ever-rising prices brings implosion</i>	184
Chapter 12.3	Appraisals solely to qualify property as security <i>Justifying the buyer's price is another matter</i>	189
Chapter 12.4	The mean price trendline: the home price anchor <i>The intersection of price illusion and reality</i>	193
Chapter 12.5	Home price bumps congressionally fed <i>A distorted demand with each new subsidy</i>	200
Chapter 13.1	S&P 500 as a complement to real estate <i>As a percent of earnings</i>	205
Chapter 13.2	REIT investments as stocks <i>Playing the real estate game from the sidelines</i>	210
Chapter 13.3	Investing: stocks or real estate? <i>Stocks: the more volatile choice</i>	218
Chapter 14.1	Boomers retire and California trembles <i>Retirees will move real estate, lots of it</i>	225
Chapter 14.2	Downsizing and relocating: the traditional retiree pastime <i>Where will retiring Boomers go?</i>	230
Chapter 14.3	Boomers bust open doors to the real estate investment era <i>Risk-averse retirees change the investment playing field</i>	234

Factor 10 Construction

Factor 11 Inventory

Factor 12 Pricing

Factor 13 Stock market

Factor 14 Retirees

Factor 15
First-time
homebuyers

Chapter 15.1 Household formations and trends in sales volume
California new housing and population aged 25-34 241

Chapter 15.2 Homeownership declines among the young
Restless, relocating with job opportunities 245

Chapter 15.3 Gen Y and Gen Z incomes and the implications for home prices
Lower incomes for Gen Y 253

Factor 16
Fiscal spending

Chapter 16.1 The U.S. Treasury, the Federal Reserve and owners
When the financial levies broke 257

Factor 17
Monetary policy

Chapter 17.1 The lender of last resort
The policies and functions of the Federal Reserve 263

Factor 18
Politics

Chapter 18.1 Rentiers and debtors: why can't they get along?
The world of passive entitlement 271

Chapter 18.2 Wall Street steps into the mortgage market
America's common enemy 279

Factor 19
Wealth from
other nations

Chapter 19.1 The global economy's effect on local real estate
Global forces make themselves at home 287

Chapter 19.2 The Federal Reserve's impact on mortgage rates
The Fed's toolbox contains interest rates 292

Factor 20
Taxation

Chapter 20.1 A nation's housing policy as tax loopholes
Tax credit subsidies in action 299

Chapter 20.2 The home mortgage tax deduction: pros and cons
Housing subsidies encourage indebtedness and turnover, not homeownership 303

Chapter 20.3 Recent tax changes
Changes to itemized, standard deductions 308

Chapter 21.1	Golden State population trends <i>Population change: the last thirty years</i>	315
Chapter 21.2	Immigration's impact on the housing market <i>The old role of immigrants in the new real estate paradigm</i>	322
Chapter 21.3	Population growth exceeds new housing; rents rapidly rise <i>More households than housing</i>	325
Chapter 22.1	The distribution of California's human resources <i>Your gain from local demographic information</i>	329
Chapter 22.2	Age and education in the Golden State <i>Age and propensity to own</i>	335
Chapter 23.1	The economic impacts of pandemics <i>COVID-19's hard hit to the economy</i>	343
Chapter 23.2	Real estate professionals, socially distanced from clients <i>Shut in but eager to buy</i>	349
Chapter 23.3	Eviction, foreclosure moratoriums build the shadow inventory <i>A moratorium on foreclosures</i>	355
Chapter 23.4	Remote work transforms the commercial real estate market <i>Demand for industrial space surges</i>	359
Chapter 24.1	Energy efficiency 101: for California real estate agents <i>Energy efficiency: what's the big deal?</i>	363
Chapter 24.2	A property's energy demands: an evolving factor in marketing <i>The greener future is at hand</i>	369
Chapter 25.1	Los Angeles County housing indicators <i>A long, investor-driven recovery</i>	377
Chapter 25.2	Orange County housing indicators <i>The recovery that never occurred</i>	386
Chapter 25.3	Riverside County housing indicators <i>Suburban demand grows the housing market</i>	393

Factor 21 Population growth

Factor 22 Demographic change

Factor 23 Pandemic

Factor 24 Energy consumption

Factor 25 Regional housing indicators

Chapter 25.4 Sacramento County housing indicators
Government jobs support the housing recovery 400

Chapter 25.5 San Diego County housing indicators
A transitory population fuels turnover 407

Chapter 25.6 San Francisco County housing indicators
A step ahead of the rest of the state 414

Chapter 25.7 Santa Clara County housing indicators
The tech industry feeds price increases 422

Glossary

Defines key terms and supplies page references for further study. 429

Quizzes

Quizzes 439

Quizzes Answer Key 451

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Chart Title	Page
3-month Treasury bill rate.....	47
6-month Treasury bill rate.....	48
10-year Treasury note rate: avg. market yield.....	13
10-year Treasury note rate.....	47
12-month Treasury average.....	49
30- and 15-year fixed FRM rates vs. 10-year Treasury note average.....	49
91-day Treasury bill rate.....	47
Annual residential construction in California.....	156
Applicable federal rates.....	45
Average annual homeownership rate by California county.....	94
Average 15-year FRM rate for California.....	48
Average 30-year FRM rate for California.....	48
Average 30-year FRM rate and mortgage funds available.....	34
CA dwellings by owners vs. tenants: 2006, 2020.....	92
California buyer purchasing power index and home prices.....	34
California gross domestic product (GDP) and per capita income.....	149
California household size and characteristics.....	147
California mean price trendline.....	195
California annual home sales volume.....	80
California monthly home sales volume.....	80
California new housing and population aged 25-34.....	242
California payroll employment.....	2
California population aged 25-34 and 65+.....	227
California population & growth rate.....	316
California tri-city average tiered property price index: 1989-present.....	178
California tri-city average tiered property price index: 2006-present.....	178
Chained CPI versus traditional CPI (2000=100).....	310
Cost of funds index (COFI).....	43
Discount rate.....	41
Federal funds rate versus 10-year treasury note rate.....	293
Home price index vs. stock price index: 1989=100.....	219
Home sales volume and pricing in California.....	29
Homeowner vacancy rate and SFR construction starts in California.....	168
Homeownership by age: western region U.S.....	227
Household employment characteristics.....	148

Table of market charts

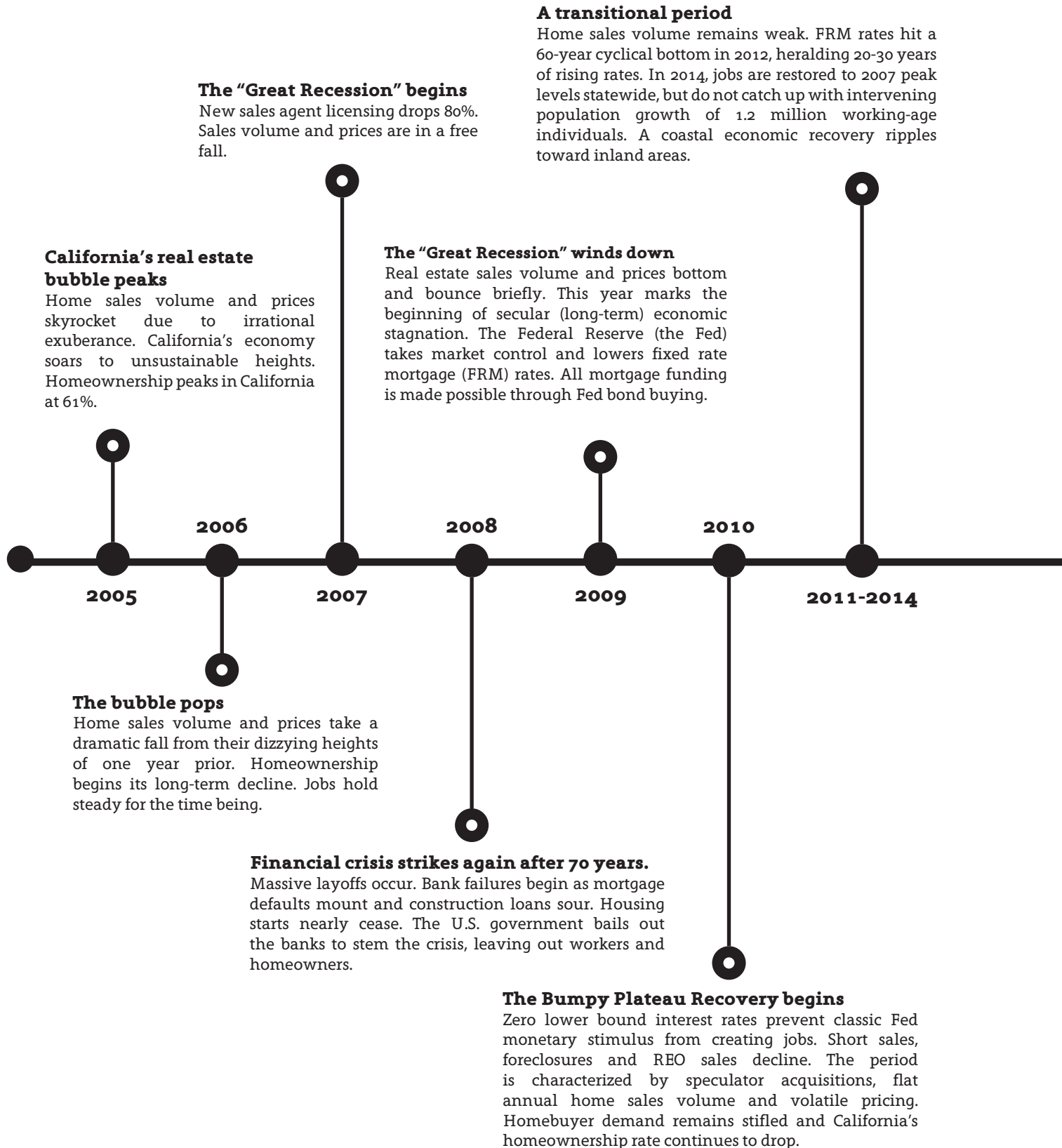
Chart Title	Page
Income inequality in California and average income.....	150
London Inter-Bank Offered Rate (LIBOR)	50
Los Angeles County employment by top industries.....	383
Los Angeles County employment: construction and real estate.....	383
Los Angeles County homeownership rate.....	380
Los Angeles County monthly construction starts	382
Los Angeles County monthly home sales volume	378
Los Angeles County per capita income	384
Los Angeles tiered property pricing: 1989-present.....	177, 382
Los Angeles tiered property pricing: 2006-present.....	177
Los Angeles County turnover rate owners and renters.....	380
Mortgage funds available to an average income household.....	33
Northern California median age	336
Northern California percent of population with a BA/BS Degree	340
Northern California percent of population with a high school diploma ..	338
Orange County monthly construction starts	389
Orange County employment by top industries.....	390
Orange County employment: construction and real estate.....	390
Orange County monthly home sales volume	387
Orange County homeownership rate	388
Orange County per capita income	391
Orange County turnover rate: owners and renters	388
Per capita income in Northern California	332
Per capita income in Southern California.....	331
Personal savings nationwide as a percent of disposable income.....	141
Personal savings nationwide as a percent of disposable income (2005-present).....	143
Population of Northern California's five largest counties	318
Population of Southern California's five largest counties	318
Prime rate	44
Quarterly percent earnings and pricing: S&P 500.....	207
Quarterly price-to-earnings (P/E) ratio: S&P 500	207
REIT indexed values and returns.....	214
Rental/homeowner vacancies	168
Rental vacancy rate and multi-family construction starts in California ..	168

Chart Title	Page
Riverside-San Bernardino-Ontario metro area construction starts	396
Riverside County employment: construction and real estate	397
Riverside County monthly home sales volume	394
Riverside County per capita income	398
Riverside County homeownership rate	395
Riverside County turnover rate: owners and renters	395
Sacramento County monthly construction starts	402
Sacramento County monthly home sales volume	401
Sacramento County employment: construction and real estate	404
Sacramento County homeownership rate	401
Sacramento County per capita income	405
Sacramento County payroll employment	404
Sacramento County turnover rate: owners and renters	402
San Diego County monthly construction starts	410
San Diego County employment: construction and real estate	411
San Diego County homeownership rate	409
San Diego County monthly home sales volume	408
San Diego County per capita income	412
San Diego tiered property pricing: 1989-present	177, 410
San Diego tiered property pricing: 2006-present	177
San Diego County turnover rate: owners and renters	409
San Francisco County monthly construction starts	417
San Francisco County employment: construction and real estate	418
San Francisco County monthly home sales volume	415
San Francisco County homeownership rate	416
San Francisco County per capita income	419
San Francisco County payroll employment	418
San Francisco tiered property pricing: 1989-present	178, 417
San Francisco tiered property pricing: 2006-present	178
San Francisco County turnover rate: owners and renters	416
Santa Clara County monthly construction starts	425
Santa Clara County employment: construction and real estate	426
Santa Clara County monthly home sales volume	423
Santa Clara County homeownership rate	424
Santa Clara County per capita income	426

Chart Title	Page
Santa Clara County payroll employment	425
Santa Clara County turnover rate: owners and renters	424
SFR and multi-family housing starts: semi-annual phases ending June and December	155
Southern California median age	336
Southern California percent of population with a BA/BS Degree	340
Southern California percent of population with a high school diploma ..	338
Treasury securities average yield	42
Yield spread	19
Yield spread and home sales volume.....	27

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California's Economic Recovery Timeline



Recession hits

As the triple whammy of a business recession, financial crash and pandemic hit in Q1 2021, home sales volume plummets in Q2 rather than experiencing the annual spring rise. By mid-year, job losses hit record heights. But by year's end, job losses are halved and home sales volume fully recovers, boosted by record-low mortgage interest rates funded by the Federal Reserve (the Fed). Government stimulus provides two injections of spending money into the economy, while paycheck program (PPP) grants keep employees on payroll.

The government removes fiscal support

With the last round of federal stimulus payments distributed in the first half of 2021, the effects of government intervention have been fully absorbed. Further, the end of the federal foreclosure and eviction moratoriums means the housing market is on its own beginning in 2022, and property prices flatten and decline. Absent a robust delivery of 2021's infrastructure bill, the responsibility for future economic growth is with private enterprise. Home inventory remains low, keeping prices from falling too far, while rental demand subsidies and multi-family vacancies rise. In the second half of 2023, an uptick in speculators produces a bottom in home prices. Heading into 2023, labor force participation (LFP) is at a low point as the influence of fiscal stimulus fades into the rearview mirror.

The market adjusts to higher interest rates

Home prices level off in Q3 2018, pulled back by waning homebuyer demand as California's home inventory begins to rise. Interest rates increase through much of 2018, significantly reducing buyer purchasing power. After years of level-to-weak sale volume, home sales volume begins to fall in the second half of 2018, remaining flat-to-down in 2019. Construction starts decrease slightly, despite rising need for additional housing. The yield spread — the time-tested marker of a coming economic recession — hits zero in early 2019, forecasting a recession to arrive 12 months later.

2015-2016

2018-2019

2020

2021

2022-2023

2024+

Obstacles to expansion

Home sales volume rises gradually in 2015 as buyer-occupants take advantage of low fixed rate mortgage (FRM) rates, only to level off in 2016 and 2017. Mortgage rates begin their long-term ascent in late-2017. Construction starts for multi-family properties fall back in 2016, with SFR starts at a reduced, but positive, pace.

Short recession casts a long shadow

Serious mortgage and rental delinquencies rise as a result of 2020's net job losses, while moratoriums on foreclosures and evictions keep residents housed through Q3 2021. Households begin a significant migration into the suburbs where construction is permitted. Baby Boomers retire, often early, selling in suburbia, mostly buying lesser-priced housing arrangements where their children live. Despite ongoing job losses, home prices increase rapidly fueled by buyer fear-of-missing-out (FOMO) and relocation, amplified by fewer sellers to go around and historically low mortgage rates. Low for-sale inventory and fast rising prices avoid a foreclosure crisis like the 2008 recession.

The real estate market stabilizes

The housing market begins to recover, working its way past 2020 recession conditions by 2024. Pricing slips back toward the historical mean-price trendline and re-anchors to consumer inflation, price increases held down by higher rates of construction and higher mortgage and cap rates. Rising interest rates cause residential income property values to suffer as investor demands shift focus from value increase for profit to higher income yields as experienced in the 1950s and 60s. §1031 property replacement transactions are limited mostly to sales of undeveloped land. Construction recovers and flourishes, as legislation induces cities to zone to meet demand from all nature of homebuyers. Homeownership stabilizes in California around 55%. Turnover increases alongside demand. Brokers and agents are again enveloped in a stable period of financial growth.

Factor 1: Jobs



Employment: a prerequisite to renting or owning



After reading this chapter, you will be able to:

- apply employment trends to your local real estate industry; and
- anticipate real estate sales volume and price movement in the months ahead.

real demand

Of all the factors affecting California real estate, **employment** has the most impact. This is true in good economic times, and times of economic recession and financial crisis.

Without jobs, wage earners have *insufficient financial ability* to make rent or mortgage payments. Thus, the unemployed are forced to move in with relatives or friends, negatively impacting the housing market and the economy.


Chapter 1.1

Learning Objectives

Key Terms

Income for the necessities of life

Figure 1
California
Payroll
Employment


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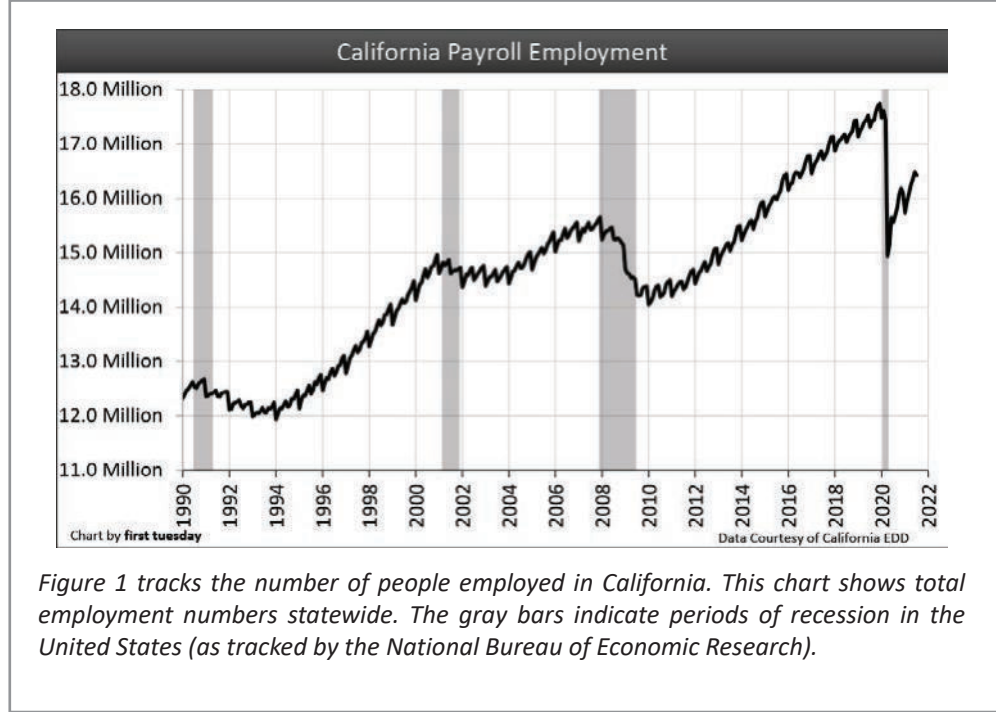


Figure 1 tracks the number of people employed in California. This chart shows total employment numbers statewide. The gray bars indicate periods of recession in the United States (as tracked by the National Bureau of Economic Research).

High unemployment stems from inability of businesses to provide employment — work. When the economy is slow, businesses have less need to occupy and use retail space, office suites, warehouses for inventory and distribution, industrial buildings for production or land for development. Thus, **commercial real estate** experiences high vacancy rates, and much rented space goes unused — a temporary wasting of allocated capital.

Demand (**real demand**, as opposed to artificial demand stimulated by hit-and-run speculators) rises for all types of real estate when local jobs increase, as during periods of economic development. Additions to the local labor force tend to drive up rents and property prices in the vicinity when the point of optimal occupancy has been reached. On the other hand, a decline in the number of local jobs reduces the need for all types of real estate, as during a recession. [For a discussion of artificial speculator demand, see Factor 3: Real estate speculation]

Jobs set the trend

The current trend in the number of individuals employed in a region sets the direction for:

- the volume of rentals and sales during the following 12 to 18 months; and
- the price movement of rents and prices paid for the use and occupancy of real estate during the following 24 to 30 months.

Job issues which affect the level of rents and prices paid for property include:

- the *quantity* of employed individuals;

real demand
The demand of end-user buyer-occupants in the real estate market.

- the *quality* of existing jobs;
- the level of wages paid; and
- the *type* of jobs existing and developing in the local market.

Historically, California jobs create homeowners and tenants on an approximate 50:50 basis, with half of all households owning the residence they occupy and the other half renting it. This number leaned toward more homeowners and fewer tenants during the Millennium Boom. However, the homeownership rate declined rapidly in the decade that followed the bust, resting around 54% in mid-2021. [See Factor 4: Homeownership]

The appreciation or depreciation of property values is triggered by increases or decreases in local population density and the economics (numbers and pay levels) of local jobs.

Of California’s largest counties, San Francisco experienced the quickest job growth after the 2008 recession. San Francisco has far surpassed its pre-recession levels, even accounting for population gain. This is largely due to the area’s bubble-prone technology industry. California’s job market finally caught up with population gain in 2019, just in time for the 2020 recession to arrive and wipe out years of job growth in a single month. [See Factor 25: Regional housing indicators]

The unemployed and underemployed are of little to no concern to the real estate market. Unemployment numbers tell us only who cannot participate in the real estate industry, but are here somewhere. This was the exception in 2020-2021, when jobless homeowners and renters were given the opportunity to remain housed thanks to the foreclosure and eviction moratoriums. In typical economic times, individuals who work to earn a living, the 99%, first need a full-time job before they can buy or rent.

See Figure 1 for historical and current projections of the number of people employed in California.

Employment is the single most important factor in determining the future vigor of the real estate market.

The number of employed individuals and the rate of job creation set the trend for sales and rental volume in the following 12 to 18 months. The employment numbers set price movement during the following 24 to 30 months.

real demand pg. 2

Quantity of employed individuals

Chapter 1.1 Summary

Chapter 1.1 Key Term

Chapter 1.2

Jobs move real estate

Learning Objectives

After reading this chapter, you will be able to:

- observe the importance of an individual’s creditworthiness;
- understand the effect of savings on the decision to buy or rent; and
- recognize the importance of regional-specific job numbers.

Key Term

creditworthiness

Jobs’ impact on real estate

The quantity of jobs in California directly impacts homeownership. Without a paycheck, nobody can afford to rent an apartment, or buy a house. Exceptions occur if they are subsidized by the government or possess substantial independent wealth.

creditworthiness

And individual’s ability to borrow money, determined by their present income and previous debt payment history.

The basis for an individual’s **creditworthiness**, essential if they are to rent or borrow money for housing, is:

- a paycheck;
- self-employed earnings from a trade or business; or
- income from investments and pensions.

Creditworthiness largely determines whether an individual is acceptable to buy or rent.

For instance, a jobholder’s decision to become a homebuyer is influenced by:

- the amount of savings available for a down payment;
- a lender’s willingness to lend to the homebuyer; and
- the value of government promises for purchase subsidies.

In application to California

California has 8.2 million single family residential (SFR) units and 5.6 million multi-family units as of the 2019 Census — just under 14.4 million housing units total (not counting mobilehomes or other forms of housing). 13.2 million of California’s 14 million housing units are occupied. There are just over 16.4 million individuals employed, as of July 2021.

53.9% of households in California own the home they live in as of Q2 2021, representing over 7.3 million owner-occupied housing units. The percentage peaked in 2006 at 61% and is certain will not rise much above California’s historical rate of 55% until the recovery from the 2020 recession.

Accordingly, for every ten jobs lost by a drop in total employment, three to five people will be unable to purchase or retain their home for loss of their sole source of income. When an individual loses a job, these short-term unemployed usually find a job within weeks and thus no drop in total employment statistics take place.

California's unemployment rate was at 7.6% in July 2021. However, the declining **labor force participation (LFP)** rate means the number of unemployment individuals is higher than at first glance. Those unemployed without large cash reserves simply cannot afford to make payments and will lose their housing upon expiration of the foreclosure and eviction moratoriums, occurring here in California on September 30, 2021. Looking ahead to a full recovery, the reverse occurs when jobs are gained.

The loss of jobs has a ripple effect on all types of real estate beyond single family residences (SFRs). As employees are shed within a region, the need for office, commercial and industrial space is reduced by an equal or greater amount. Subleases, reduced rents and vacant space across all segments of California's real estate economy are the direct result of overall job loss.

During the last housing cycle, the job losses of 2009-2010 were slowly regained over the next decade, finally returning to pre-recession levels in 2019. As we look ahead to the recovery from the 2020 recession, we are still several years away from a full recovery of all jobs lost in 2020. As of July 2021, jobs are still 1.3 million below the pre-2020 recession peak and the timing and speed of this recovery will largely depend on job creation, be it through immediate government intervention or an organic return of jobs over the next two-to-three years.

Readers often observe payroll data as reported by the media or others, which too often is **national**, not local. However, you need to distinguish between what is happening to California jobs and what is taking place across the rest of the nation. What happens in a commodity economy (such as Texas or North Dakota) has little relationship to what happens in California, a services economy.

California's homeownership rate has declined over seven percentage points since its peak in 2006. In contrast, the nationwide homeownership rate has declined only four percentage points from peak levels. [See Factor 4: Homeownership]

California took a disproportionately greater hit to jobs during the Great Recession in comparison to the national averages. This is largely due to the magnitude of California's real estate construction bubble leading up to the crash and the 2008 recession. The bubble exceeded those of all other states (except Nevada and Florida) in terms of price, lending, construction, speculation and anticipation of demand. The bust had an equally substantial impact on our state's economy as it returns to the trend lines that were ignored in the interim.

**There's no
place like
home**

Chapter 1.2 Summary

Creditworthiness and savings are both homebuyer necessities. The quality of creditworthiness and amount of savings determines what type of home the buyer can purchase. Both depend on jobs.

After over a decade of gradual improvement, California's jobs market finally achieved a full recovery in 2019 when accounting for the working-aged population increase of roughly 1.8 million since the Great Recession took hold in 2008. Employment in California reached a full recovery just in time to reverse course in 2020.

The 2020 recession was the shortest on record, and yet its effects have been long in the labor market. As each round of government stimulus focused on band-aid solutions rather than job creation, expect the jobs recovery to continue its faltering progress for years to come. For reference, California still needs to regain 1.3 million jobs lost in 2020 as of July 2021.

Local data need to be sought when measuring jobs performance. Accordingly, a nationwide employment picture does not apply to California.

Chapter 1.2 Key Term

creditworthiness pg. 4

Factor 2: Interest rates



Long- and short-term rates

Chapter 2.1

After reading this chapter, you will be able to:

- interpret the effect long- and short-term rates have on real estate pricing and mortgage risks; and
- understand the relationship of interest rates to buying, selling and ownership.

adjustable rate mortgage (ARM)

capitalization rate

inflation

invested capital

fully indexed rate

long-term rate

put option

short-term rate

Learning Objectives

Key Terms

Interest rates are divided into two basic categories: **short-term** and **long-term**. Property buyers and their agents need to distinguish the unique attributes of these rates, their distinct uses in mortgage analysis and property evaluation, and understand the different risks of loss presented by each.

Long-term rates are fixed for the duration of the mortgage, until fully amortized by payments or due by a final/balloon payment. The fixed rate

Financing for ownership of real estate goes long

long-term rate

An interest rate fixed for the duration of the mortgage.

inflation

The price changes over time in consumer goods and services, quantified in the consumer price index.

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.

invested capital

The total amount of cash and mortgage principal an owner has used to acquire and improve a property.

feature makes them compatible with the ownership fundamentals of all types of real estate. This is because real estate is an appreciable asset, a collectible held by investors and homeowners over a decade or two.

Long-term rates for mortgages and investor ownership of real estate both have a built-in hedge against **inflation**. The anticipated rate of consumer inflation — the target rate for which is set by the Federal Reserve (the Fed) at 2%-3% annually — for the next 10 years is figured into the pricing of both; in the note rate for a mortgage and in expected future rent increases controlling property value.

In another parallel, both a fixed-rate mortgage (FRM) and real estate have a present value based on application of a **capitalization (cap) rate**.

The *cap rate* is determined by the ratio of income (interest or net rent) to the **invested capital** (the mortgage amount or purchase price). Lenders and property owners ultimately seek a real rate of return over and above future inflation expectations at the time the mortgage is funded or the property investment is made, called the *inflation premium*. Thus, the anticipated rate of future inflation is a significant component of the interest rate charged and the cap rate setting the price a buyer pays for a property.

As a result, when long-term rates rise, so do cap rates. Both rise for the same reasons:

- expectations of future increased inflation; and
- future increased demand or restrictions on the money supply.

A rise in long-term interest and cap rates translates into a corresponding drop in prices investors and homebuyers will pay for real estate, unless the rate rise is offset by a concurrent rise in rents (which will not occur normally).

Conversely, when long-term rates decline continuously as took place between 1982 and 2012, the pricing of real estate will rise. In each cycle of price movements, it takes 9-12 months for the impact of a rate change to trigger a pricing reaction among brokers, agents, sellers and buyers, depending on whether rates are declining or rising. As mortgage rates rise, sales volume will decrease. In turn, approximately 12 months after sales volume decreases, prices begin their decline, delayed by the sticky price syndrome not present when prices rise.

Volatile short-term rates

short-term rate

A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.

Alternatively, *short-term* rates are incompatible with real estate ownership. The primary reason: real estate is a collectible intended to be held for a long period of time. Worse, the short-term rate is driven primarily by the Fed's unrelated fight against either inflation or deflation in the pricing of consumer goods, the epitome of short-term depreciable (consumable) assets. The short-term rate is highly volatile and does not factor in the rate of inflation as a component of the rate charged as does the long-term FRM rate.

The basic distinction between the two types of rates is that a change in short-term rates is not reflected in the pricing of long-term mortgage rates,

real estate ownership or rents. Only the anticipated rate of future inflation brought about by the Fed's use of the short-term rate to control inflation and deflation is reflected in the long-term rate.

Adjustable rate mortgages (ARMs), the mortgage product as the standard bearer for injecting short-term rates into real estate transactions (as well as rent inflation clauses in lease agreements), disregard and are in conflict with the fundamentals of real estate ownership. The nature of a variable rate of interest facilitates the borrowing of more money than a fixed rate mortgage (FRM) to buy real estate. However, ARMs make it more difficult—and thus riskier—to be able to retain encumbered real estate than with an FRM.

Further, elevated ARM use temporarily and artificially supports rising real estate prices. Thus, ARMs are a perfect fit for speculators. Speculators have no intention of occupying, renting except for a short term or retaining the property financed by the ARM, almost a “free lunch” due to the ARM's lower interest rates than FRM rates at the time of origination.

If the property does not flip soon and prices drop below the remaining ARM balance, the speculator exercises their **put option** built into the provisions of every trust deed.

Under the *put option*, the speculator forces the lender to buy the property for the remaining mortgage amount, exercising the option by defaulting. The put option is more popularly known by its less-kind moniker: **default and foreclosure**.

The distinction between long-term and short-term rates forces mortgage lenders to bet on the future demand for money and inflation – both of which are built into rates. To make an FRM, lenders need to set the rate they will continuously receive on a 30-year investment. This is no different than the investor who sets their price when acquiring real estate or a 30-year bond.

However, depository institutions as lenders tend not to calculate or bet on the future. Owners of real estate and conventional bond investors do. To avoid making this bet, institutional depository bankers convinced the U.S. Treasury to authorize their use of the ARM in March 1982. By doing so, lenders were given the ability to avoid California regulations limiting the percentage swing in interest rates to 2.5% during the life of the mortgage.

At first, the ARM was called a “topless mortgage.” It seemed the ceiling rate was set so high as to be meaningless. Thus, this type of mortgage was commonly shunned by owner-occupants. Soon, the ARM became more tightly defined as a *Reverse Interest and Principal for Optimum Fast Foreclosure (RIPOFF)* mortgage for its short-term effect on ARM borrowers. Another accurate name for ARMs was a ZAP mortgage for the borrower's too frequent *Zero Ability to Pay* when short-term rates cyclically jump to halt inflation.

Today, some of these past risks have been mitigated. Congress has removed some of the features of ARMs that made them so catastrophic to the housing

adjustable rate mortgage (ARM)

A note with an interest rate that varies based on a chosen index figure plus a set margin, the rate usually adjusting on an annual basis subject to annual and lifetime ceiling and floor rate limitations. [See **RPI** Form 320-1]

put option

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.

Long-term vs. short-term

industry. New underwriting standards (the **ability to repay** rules) require ARMs to be underwritten at the maximum allowable interest rate — the **fully indexed rate** — after five years from the date of the first payment.¹

Homeowners pay too much

fully indexed rate

The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.

To get a feel of the nature of an FRM, observe the 10-year Treasury rates. Historically, the fixed rate for home mortgages has had a margin (spread) of 1.5% above the 10-year Treasury rate. In 2010, the spread rose to double that rate due to the repercussions of Wall Street again meddling in the real estate market beginning in 2001 (the same occurred in the late 1980s).

As of September 2021, after years of being well above the historical average, the spread has finally normalized, at 1.53%. Today's 1.53% spread indicates lenders are no longer padding their interest rates, thus rates will not drop further without some outside pressure from the Fed.

Mortgage money for income property investors usually runs at rates just above the rates charged on a home mortgage. This is because the government grants no implicit or actual guarantee for those mortgage types, with the exception of some Federal Housing Administration (FHA)-insured and farm mortgage programs.

¹ 12 Code of Federal Regulations §1026.43(c)(2)

Chapter 2.1 Summary

Interest rates are divided into two basic categories: short-term and long-term. Property buyers and their agents need to distinguish the unique attributes of these rates, their distinct uses in mortgage analysis and property evaluation, and understand the different risks of loss presented by each.

The basic distinction between the two types of rates is that a change in short-term rates is not reflected in the pricing of long-term mortgage rates, real estate ownership or rents. Only the anticipated rate of future inflation brought about by the Fed's use of the short-term rate to control inflation and deflation is reflected in the long-term rate.

To get a feel of the nature of an FRM, observe the 10-year Treasury rates. Historically, the fixed rate for home mortgages has had a margin (spread) of 1.5% above the 10-year Treasury rate. As of Q3 2021, the spread has fallen to just 1.53% after years of being elevated. Today's spread indicates lenders are no longer padding their interest rates.

adjustable rate mortgage (ARM) pg. 9
capitalization rate pg. 8
inflation pg. 8
invested capital..... pg. 8
fully indexed rate pg. 10
long-term rate pg. 8
put option pg. 9
short-term rate pg. 8

Chapter 2.1

Key Terms

Chapter 2.2

30 years of summer followed by 30 years of winter

Learning Objectives

After reading this chapter, you will be able to:

- observe the cyclical pattern of rises and falls of interest rates; and
- recognize that the current half-cycle of real estate pricing is shaped by ascending mortgage rates.

Key Terms

10-year Treasury Note

net operating income (NOI)

Greenspan Put

Bond market cycles

10-year Treasury Note

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.

The average monthly **10-Year Treasury Note (T-Note)** yield since 1900 is shown in Figure 1. As demonstrated, interest rates on the 10-Year T-Note have shown an overall decline since 1980, following a rise from lows last reached in 1941. We can now see that 1940-1950 marked the beginning of what has become a 60-year rates cycle: approximately 30 years of rising rates, followed by 30 years of falling rates. This roughly mirrors the 60-year period prior to 1950, in which interest rates peaked in 1921.

As we make our way through the current 60-year rate cycle, RPI expects another slow upward run in rates for 20-30 years from the bottom (experienced in 2012, with the brief downward run in 2020 an anomaly in an otherwise upward-trending mortgage rate trend), and then a reversal into rate declines as occurred following 1980. The interest rate on the 10-Year T-Note dropped in 2020, averaging a low 0.89% in 2020 as the Euro, the Indian Rupee and the Chinese Yuan all weakened against the U.S. dollar. These lows were extreme and are evidence of international monetary stress on top of unstable global trade relations.

Mortgage rates have historically moved in tandem with the 10-year T-note at a 1.5% spread. However, this 1.5% spread was elevated – at around 1.7% – for several years following 2012. This spread rose to 1.7%-1.8% in 2018-2020 as lenders, cautious about the future economic outlook, padded their risk premiums.

After hitting historic lows in 2020, the 10-year T-note has since bounced back, shrinking the spread back to its historical benchmark of 1.5%. The upcoming period of rising rates is likely to last for quite a long time – two-or-three decades. The last three cycles in bond market rates have been extremely

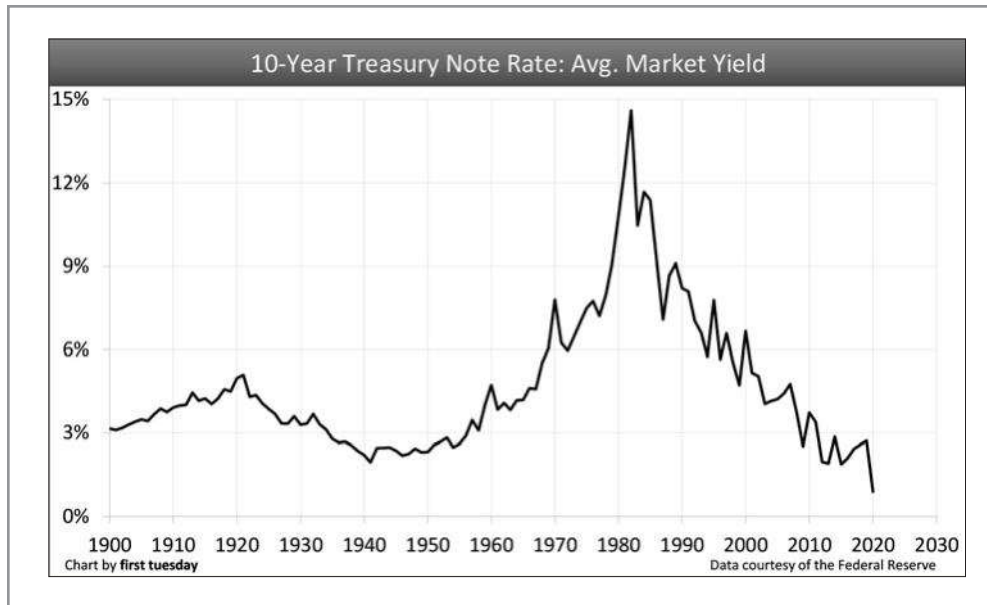


Figure 1

10-Year Treasury
Note Rate: Avg.
Market Yield

**ONLINE UPDATE**

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

regular, consisting of a 27-year downtrend in rates (1922-1949), followed by a 32-year uptrend (1949-1982) and another 30-year downtrend that ended in 2012 when rates were then at historic lows.

While the regularity of this pattern of 30-year passages should be considered coincidental (they very easily might have been forty years, or twenty), precedent establishes that bond market rate changes are much slower and more gradual than, say, changes in the stock market.

In previous interest rate cycles, rates rose for approximately thirty years, peaking in 1921 and again in 1979 after rising from essentially zero in the late 1940s, following the recovery from the Great Depression.

In 1947, at the end of World War II, interest rates on the 10-year T-Note were near zero, much as they are today. Then, from 1947 to 1979, rates moved steadily upward. 1947 is a key year for other reasons as well: it marked the end of a recession, and a long-awaited return to prosperity after the Great Depression of the late-1930s.

During the resulting half cycle of rising interest rates from 1949 to 1982, the wealth of investors increased even as interest rates rose, housing construction was very strong and employment and prosperity increased as well. The *American Dream* of jobs, cars and homes for all was in full bloom during this period.

We expect to experience similar conditions during the next two or three decades, into the mid-2030s (this time, hopefully without the stimulus of a war effort).

Interest rates and asset pricing

What it means for the housing market

Greenspan Put

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.

For the housing market, however, rising interest rates, even static interest rates, mean that there will be no short-term profits to be had from any increase in pricing.

The notorious “**Greenspan Put**,” which we have grown accustomed to seeing after every drop in interest rates, will not and cannot be repeated to artificially generate profits in any asset market – commodities, stocks, bonds or real estate. Mortgage rates are inextricably tied to bond market rates, and every increase in bond and mortgage rates means a decrease in a homebuyer’s purchasing power – the amount they can borrow based on repayment at 31% of income – and an increase in the earnings of the **rentier class**.

Thus, a buyer will experience a decrease in the amount they can pay for a home. Less money borrowed by homebuyers means lower prices received by sellers for their properties.

Of course, this annual decrease in purchasing power is fully offset in actual (nominal) dollar terms by the Fed’s monetary policy, which maintains annual inflation around 2%. This inflation is the driving force increasing wages from year to year. As in the period of rising bond and mortgage rates from 1949-1982, prices will be held down, rising only in response to consumer inflation as permitted by the Fed and any “price appreciation” at the property’s location (appreciation occurs solely due to demographics, as **demand** for real estate within an area increases with a rise in the area’s population density or an increase in the income of that population beyond the rate of inflation). [See **RPI’s** Income Property Brokerage (IPB) suite of forms]

Interest rates in the modern era

The Fed ceased its final round of quantitative easing (QE3) in October 2014, promising to keep the short-term interest rate low (around 0.25%) until the economy improved sufficiently. The Fed stated their intention to raise interest rates by the end of 2015, and finally increased the short-term rate by 0.25% in December 2015, and several times in 2016-2018. Once it was clear an economic recession was imminent, the Fed began to take their foot off the gas, letting rates fall back beginning in 2019, rapidly dropping rates in 2020 when the recession coincided with the pandemic and markets panicked.

While FRM rates hit historic lows in 2020, rates will continue to rise over the long term. As rates continue to increase, agents will quickly learn to cope with an unfamiliar set of investment and pricing challenges (including different income multiplier/capitalization rates, long-term holding periods before profits can be taken, and Due-On Sale clause assumptions).

Future interest rates

The key lesson to remember in the upcoming years will be that real estate is most properly priced and held for its **inherent rental value**. Those who buy property for speculative gain, not rental income, will see as little success in gains from a flip as those who invested in the real estate market from 1950 to 1980, when mortgage rates moved slowly, steadily upward until they exceeded 18%.

In the last two decades, it was possible to purchase a parcel of real estate, vacant or improved, and take a profit, much greater than the rate of consumer inflation, merely by holding that parcel for a short period of time. This is no longer an option. The days of steadily decreasing interest rates, accompanied by steadily falling rents, producing ever increasing prices and profits (and \$1031 hysteria) have run their course to the bitter end.

Smart investors will look to purchase property in urban centers which have already begun to establish themselves as the most desirable abodes for the next generation of homeowners and tenants. In the long run, investors in real estate will need to increase their wealth, not by flipping their properties for profit, but by generating rental income over the course of long-term ownership.

Income property will be bought to be operated and managed for an annual **net operating income (NOI)**, capitalizing at the rate proper going forward. In boom times, property owners were accustomed to capitalization rates (cap rates) of 6% or less. For the upcoming years, 10% will be closer to the norm.

The keys to success in the new paradigm of rising rates are:

- prudent property selection;
- careful research;
- forward-looking capitalization rates; and
- a long-term commitment to real estate ownership.

net operating income (NOI)

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]

Chapter 2.2 Summary

The 10-year Treasury note averaged 0.89% in 2020. This was a brief departure from the broader rising trend that began in 2012. Interest rates rise and fall in a cycle, and the current rising trend will include two-to-three decades of rising interest rates. This will dampen home price increases, as buyer purchasing power is continually reduced.

Lenders use the 10-year T-Note to determine a homebuyer’s mortgage rate. The difference between the note rate and the 10-year T-Note rate represents the lender’s risk premium, which covers potential losses due to mortgage default on a 20% down payment, private mortgage insurance (PMI) covering the added risk of a lesser down payment.

While the 10-year rate recently peaked in 2018 around 3.2%, increased global investment in U.S. Treasuries has seen the 10-year rate fall back. In 2021, bond market investors are feeling discouraged in light of the slowing economy and instability emanating from the federal government. This has led them to accept lower yields in return for the safety of treasuries, which in turn has kept FRM rates down. While FRM rates have risen from their historic lows reached in 2020, they will not rise significantly over the next few years.

Chapter 2.2 Key Terms

10-year Treasury Note	pg. 13
Greenspan Put	pg. 14
net operating income	pg. 16

The yield spread foretells recessions and recoveries

Chapter 2.3

After reading this chapter, you will be able to:

- forecast future economic conditions facing the real estate market using the yield spread.

monetary policy

yield spread

real rate of return

Learning objectives

Key Terms

To you stalwart members of the real estate profession who weathered the storm of the Great Recession, a gift: the ability to forecast the probability of future recessions and rebounds. This famed crystal ball is the yield curve spread, simply called the **yield spread**. [See Figure 2]

Don't let the name yield spread put you off. It is not related to the deceptive yield spread premium (YSP) used by kickback mortgage lenders to secretly pay the buyer's mortgage broker for an above par rate the lender received. Instead, it's all about comparing interest rates.

While the name sounds terribly technical and esoteric, the beauty of the yield spread is that all the hard work of interpreting economic conditions is completed by bond market investors and Fed economists. All that remains for the layperson to do is locate the current margin of the yield spread, and understand the simplicity of what that yield spread margin imports. The concept uses insightful information generated by the wisdom of the crowd.

The *yield spread* is the difference between two key interest rates:

- the **10-year Treasury Note Rate** (in this case, long-term rates); and
- the **3-month Treasury Bill Rate** (or short-term rate).

Bond *market investors* set the 10-year Treasury note rate for returns on their ten-year investments in government notes, called long-term investments. Collectively, bond market investors are good at what they do. As a very large international crowd, they display great wisdom about our national economy's future.

To know how your market will evolve

yield spread

The difference between the 10-year Treasury Note rate and the 3-month Treasury Bill rate, forecasting economic conditions one year forward.

The margins and probabilities

Pulling from an immense breadth of information and understanding, every day they re-determine the rate they require on their long-term investments (bonds issued by government, business and real estate mortgage sectors).

Their personal interest in the success of their **long-term investments** provides us with a ready gauge for what they collectively determine will be our economic conditions in the future.

monetary policy

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.

To make a profit on these long-term investments, bond market investors take into account the Fed's **monetary policy** and the resulting economic conditions that policy places on markets in the future. These millions of private individual and institutional forecasts of future economic conditions are translated into the rate they will accept at the time they purchase a 10-year Treasury note. [See Factor 17: Monetary policy]

Their considerations encompass two discrete elements:

- the perceived future rate of inflation, called the *inflation risk premium*, a figure built into the 10-year Treasury note (T-note) rate, as controlled by the Fed in its frequent setting of short-term interest rates; and
- the desired fixed rate of return on the investment in excess of the future rate of inflation, called the **real rate of return**.

real rate of return

The desired fixed rate of return on the investment in excess of the future rate of inflation.

The short-term market rate

The second piece of information needed to calculate the yield spread is the interest rate on the 3-month Treasury bill. The 3-month interest rate is managed by the Fed as the base price for borrowing money over a short-term, say five years maximum.

The Fed has direct control over this rate (through its Federal Funds Rate), and uses short-term rates as a tool to either:

- *stimulate business and economic growth* to stave off deflation and economic stagnation — jobs — by lowering the interest rate and allowing banks (and through them, businesses and consumers) to borrow money easily and cheaply; or
- *dampen business and slow economic growth* to fight inflation and excess demands for labor by raising the interest rate at which banks may borrow money (and in turn increase the cost of borrowing by businesses and consumers).

Collectively, the Fed's use of short-term interest rates and other infusions and withdrawals of dollars in circulation to control the economy is known as monetary policy.

Interplay between the Treasury rates

Calculating the yield spread is simply a matter of subtracting the 3-month Treasury Bill Rate from the 10-year Treasury note. The magnitude of the difference between the rates gives the yield spread its predictive power.

The Fed's use of *monetary policy* to lean against inflation or deflation gives bond market investors data on how inflation will play out in the future.

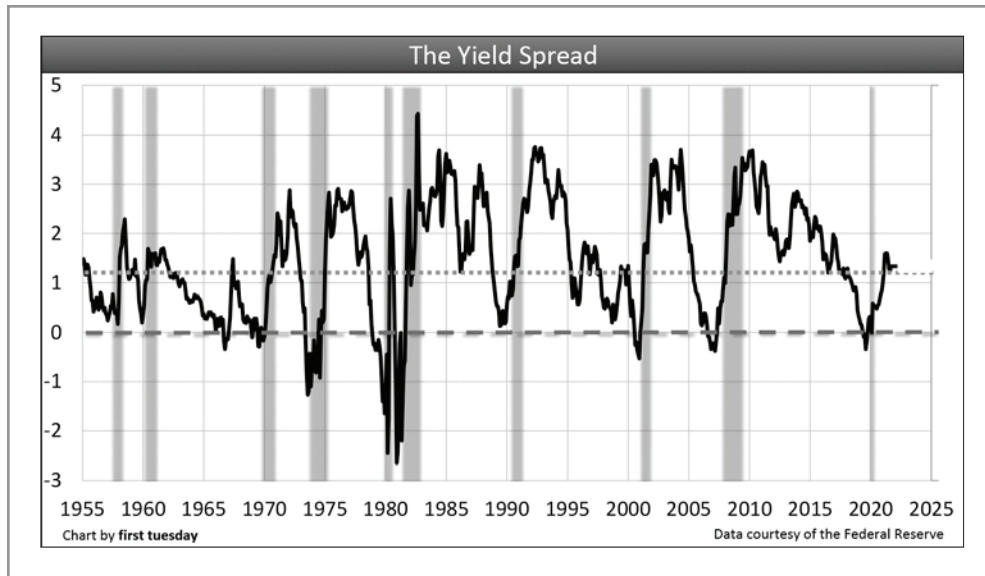
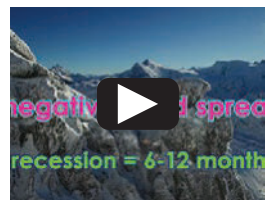


Figure 2

The Yield Spread

**ONLINE UPDATE**

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[Click to watch](#)

Bond market investors look at the Fed's current use of short-term rates in their constant fight with inflationary and deflationary pressures to determine the likely forward impact of the Fed's actions. [See Factor 17: Monetary policy]

These investors then set the rate they will accept on 10-year T-notes to:

- recapture the annual loss they anticipated in the dollar's purchasing power due to the Fed's action — the inflation risk premium; and
- to earn their desired future *real rate of return* in addition to inflation.

On any given day:

- *short-term interest rates* indicate what the Fed is doing to combat inflation (or deflation) or address any other deviation from acceptable consumer prices and job market conditions; and
- *long-term interest rates* reflect the bond market's judgment of the effect the Fed's short-term actions will have on the economy long-term, and in turn the earnings on their investments.

Generally, a low or *declining yield spread* indicates a less vigorous economy one year forward. This declining yield spread is often the result of bond market investors seeing less future growth resulting from the Fed's short-term rate activity. One such activity is the Fed raising short-term rates to combat an increased risk of inflation or a tight labor market. This scenario predicts the percentage likelihood of an economic recession one year forward. [See Factor 17: Monetary policy]

On the flip-side of an economic cycle, a higher or *rising yield spread* indicates a more vigorous future economy — or at least one that is not in much danger of recession one year forward. While good for bond market investors whose actions are full-speed-ahead for profit, a too-high yield spread (and its

**Less vigorous
or more
vigorous**

resulting boom) poses a danger of inflation. When this occurs, the Fed at some point acts to curtail the growth of future jobs and stabilize consumer prices by raising short-term rates. [See Factor 8: Inflation & CPI]

*Editor's note — After over a decade of positive activity, the yield spread went negative in mid-2019 for an extended time, bouncing back into positive territory towards year's end. 2019's four-month inversion was the result of higher short-term interest rates stimulated by **the Fed** and lower long-term rates as the economy slowed and bond market investors saw fewer investment opportunities, and followed a long downward trend that began in 2014. With these advance warnings, **real estate professionals** had an opportunity to prepare for the 2020 recession, which began officially in February 2020.*

An over correction in the Fed's fight to keep inflation at 2% can potentially send the yield spread into low or negative levels. The Fed began bumping up rates in December 2015, continuing in 2016 through 2018. Their objective has been to create a monetary and fiscal environment ripe for more consumer price inflation to achieve their 2% annual inflation level. [See Factor 17: Monetary policy]

In September 2021, the yield spread was back in positive territory, but still low, averaging +1.33. The market contraction produced by the coronavirus-induced economic shutdown and supply-chain disruption caused investors to seek the safety of U.S. Treasuries, pushing the 10-year Treasury Note to historic lows early in 2020. Since then, the 10-year T-Note has bounced back as bond market investors show more interest in riskier, non-government investment opportunities. The Fed's response has been to drop and hold the Federal Funds rate, while the 3-month Treasury has plummeted and remained near zero.

Zero lower bound rates

Any Fed misstep by raising short-term rates before the time is right, or at too quick a pace to correct a growing inflation outlook (say beyond 3%), which the Fed is prone to do, might result in a poorly timed recession, rather than the normal business recession that the Fed has in mind. Likewise, the Fed, at the urging of politicians, may reign in interest rate increases too soon, avoiding cooling down the economy. This would have disastrous consequences down the line, as when the Fed halted their efforts to raise the short-term rate in 2001, resulting in the excesses of the Millennium Boom and the later crash and 2008 recession.

The Fed's 3-month rate remains at zero in 2021. We are just nine years into the current roughly 60-year rate cycle in 2021: historically around 30 years of rising rates followed by 30 years of falling rates. Therefore, while rates will fluctuate slightly, the overall trend will be up for the next two decades. [See Chapter 2.2]

Estimated Recession Probabilities for Probit Model Using the Yield Curve Spread

Four Quarters Ahead

Recession Probability (Percent)	Value of Spread (Percentage Points)
5	1.21
10	0.76
15	0.46
20	0.22
25	0.02
30	-0.17
40	-0.50
50	-0.82
60	-1.13
70	-1.46
80	-1.85
90	-2.40

Note: The yield curve spread is defined as the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill.

This figure indicates the likelihood of recession based on the current yield spread.

[Figure courtesy of Arturo Estrella and Frederic Mishkin for the U.S. Federal Reserve, 1996.]

Figure 3

Estimated
Recession
Probabilities for
Probit Model
Using the Yield
Curve Spread

Figure 2 tracks the yield spread from January 1954 through September 2021. The vertical gray bars represent periods of recession. The top horizontal line represents the point at which the probability of recession begins, as assigned in the 1980s by Fed economists Estrella and Mishkin. Under Estrella and Mishkin's analysis, yield spreads smaller than 1.21% predict successively greater probabilities of recessions one year forward.

Remember that truths told by prognosticators, even ones as erudite as the Fed wizards, are still beholden to existing economic conditions.

Figure 3 gives a theoretical Fed perspective of when recessions will occur and their severity. However, a yield spread chart (such as Figure 2) provides an even quicker judgment of a coming recession (or rebound) one year forward, no matter its degree of severity. [See Figure 3]

**Interpreting
the yield
spread chart:
the Fed way**

Interpreting the yield spread chart: the quick and easy way

The bottom horizontal line in Figure 2 represents zero. The yield spread dips below zero when the short-term rate rises above the long-term rate, called an inversion. Yield spread inversion signals a crossover disturbance in the two rates controlling the yield. [See Figure 2]

A yield spread inversion forewarns of a recession due to:

- the bond market reducing its forecast for future demand for money in preparation for a downturn in the economy; and/or
- the Fed having continuously raised short-term interest rates to correct inflation, loose credit or tight job market conditions.

Observe on the chart that a recession follows *nearly one year after each inversion of the yield spread*, and sometimes even after a near-inversion of the yield spread. [See Figure 2]

Whether brought about mainly by the bond market's low confidence in the future conditions of the economy, or a consistent and continuing short-term rate change by the Fed, this inversion always flags an economic slowdown one year forward.

That crossover moment gives real estate brokers and agents another signal to adjust their conduct to match a measurably reduced volume in sales (which will already be slipping), lending and leasing one year forward. Then within another year, you will see a drop in prices, mortgage rates and rents.

Real estate's stake in the yield spread

Real estate was a key player contributing to the excesses that brought about the 2008 recession and financial crisis. The yield spread was clearly decreasing in the years prior to the implosion of the real estate bubble.

The Fed's concerted effort to raise short-term rates to lean against the excesses began mid-2004. However, it came too little too late, and only after allowing the market to go hog-wild for too long — an observation derived from hindsight.

Now, the collective efforts of in-the-know real estate professionals will nurse the real estate market back to health. Going forward, more and more brokers and agents need to understand the workings of the yield spread as a gauge of the economy's direction for the coming 12 months.

Only then, with this insight, will the industry-wide frenzy to over-build, over-price and over-sell be tempered. The steady direction taken by the levelheaded professionals within the real estate industry will be the redeeming factor. Do not expect this conscientious group to include the large media brokers with several hundred agents and brokers in their employ.

Parting message

How can brokers and agents prepare for a forthcoming recession? These forward-thinking professionals can seek out recession-proof niches of real estate (such as real estate owned (REO) sales, or property management) in which to weather the storm.

Parting message? Keep the yield spread at hand. Consider it when making business decisions. You now know it will pay off as soon as the coming year.

The yield spread is the difference between two key interest rates:

- the 10-year Treasury Note Rate (in this case, long-term rates); and
- the 3-month Treasury Bill Rate (or short-term rate).

The magnitude of the difference between the rates gives the yield spread its predictive power.

Generally, a low or declining yield spread indicates a less vigorous economy one year forward. This declining yield spread is often the result of bond market investors seeing less future growth resulting from the Fed's short-term rate activity.

On the flip-side of an economic cycle, a higher or rising yield spread indicates a more vigorous future economy — or at least one that is not in much danger of recession one year forward.

monetary policy	pg. 18
real rate of return	pg. 18
yield spread	pg. 17

Chapter 2.3 Summary

Chapter 2.3 Key Terms

Chapter 2.4

How to time the market

Learning Objectives

After reading this chapter, you will be able to:

- understand the best time to buy, sell or hold real estate; and
- anticipate the market to maximize profit.

Key Terms

buy phase

end users

hold phase

inventory

sell phase

yield spread

To buy or sell in 2022?

These market charts are your investment planner. They tell you when a business cycle will enter a **buy phase** or **sell phase**.

The best action for today’s housing market can be found by examining three factors:

- *the yield spread* (which forecasts future economic performance one year hence and is the difference between the 10-year Treasury Note and the 3-Month Treasury Bill rates) [See Chapter 2.3];
- *home sales volume* (which forecasts home price movement nine months hence); and
- *home pricing* (the crucial factor of whether rental rates – as a base for applying a capitalization rate a prudent investor will use to discount future Net Operating Income (NOI)) – supports current pricing). [See Factor 12: Pricing]

The situation:

As of September 2021, the yield spread was +1.33, up from +0.57 one year earlier when the economy was still reeling from the 2020 recession. Today’s yield spread is up from the negative spread seen in 2019, which presaged the 2020 recession. However, while positive in 2021, the yield spread remains low, indicating a sluggish general economic outlook in the next 12 months as the **recession hangover** continues.

Further, mortgage rates dropped to historic lows in 2020, but have since bounced back, reigning in purchasing power. Higher interest rates tend to pull back home sales volume, portending a slipping housing market in 2022. As depicted in Figure 4, home sales volume has shown a dramatic change from quarter to quarter, but little long-term change since 2009. Total sales in 2015-2020 were essentially flat. [See Figure 4]

California's flat home sales volume continues the bumpy plateau recovery experienced this past decade. A falling sales volume forecasts decreasing pricing nine months hence, absent other market influences. However, while sales have been flat since 2015, home prices have continued to increase at a pace faster than increases in wages. The distortion has to do with extra market influences — including:

- **insufficient residential construction** to keep up with population increases much less catch up on homebuyer demand due to nearly 1% annual population growth since the Great Recession; and
- the recent historically low **mortgage rates** experienced in 2020.

Likewise, when sales volume is rising rapidly, home prices are also likely to rise quickly, with a lag period of around six to nine months.

Speculator interference in 2012-2013 distorted price movement, causing an unsustainable price bump for lack of anything resembling pent-up **end user** demand. Home prices were 21%-to-24% higher in July 2021 than one year earlier across all tiers of California home sales. This unstable price bump is unsupported by sales volume and wages for monthly payments, and thus is unreliable.

Price bumps are often misconstrued as cycles in and of themselves. However, they are merely the result of frenzied speculator attitudes in momentum markets to buy low and sell high within a matter of months. These short bursts in rising prices are unpredictable. You are better off not attempting to apply the factors influencing buy and sell phases to these short periods.

How can you tell the difference between a **price bump** and a more sustainable buy phase? *Price bumps* are characterized by:

- no long-term rise in the yield spread;
- no corresponding, long-term increase in sales volume; and
- unusual market factors, such as an increased speculator presence or percentage of ARM loan originations.

While prices have increased significantly over the past year, the increase has coincided directly with the increase in buyer purchasing power induced by falling interest rates. Thus, as interest rates have begun to bounce higher in 2021 and the expiration of the foreclosure moratorium occurred in Q3 2021, don't expect price increases to continue in 2022. Without fuel from decreasing interest rates and absent the support of a jobs recovery, the coming wave of forced sales will drag down home values beginning a few short months after the moratorium expires. Thus, consider 2022 a hold phase for cautious investors.

Long-term investors will hold onto their property until a future sell phase, when home values have had more time to appreciate.

end user

A buyer who will occupy the property as their residence or own it as income property for long-term investment purposes.

Price bump or sustainable buy phase?

Phase of the Real Estate Cycle

<i>Yield spread increases for 6 months (prepare for buy phase)</i>	<i>12 months pass from the start of the yield spread movement</i>	<i>Home sales volume begins to increase (buy phase begins)</i>
<i>Sales volume increases (buy phase continues)</i>	<i>12 months pass from the start of the sales volume movement</i>	<i>Home pricing increases (buy phase continues)</i>
<i>Yield spread decreases for 6 months (prepare for sell phase)</i>	<i>12 months pass from the start of the yield spread movement</i>	<i>Home sales volume begins to decrease (sell phase begins)</i>
<i>Sales volume decreases (sell phase continues)</i>	<i>12 months pass from the start of the sales volume movement</i>	<i>Home pricing decreases (sell phase ends, hold phase begins)</i>

Advanced charting: Buy, sell or wait out the market

buy phase
The ideal moment to buy property, characterized by low prices, low interest rates and few willing buyers.

hold phase
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.

sell phase
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.

The economy — being driven by humans — moves in cycles, much the way people behave as stop-and-go drivers on our freeways. The length of a cycle is determined by the extent and duration of economic excesses (go) and recesses (stop) during the cycle. The recent cycle from which we have emerged — 2001-2009 — had unprecedented levels of excess and recess.

Each real estate market cycle can be neatly divided into three phases:

The **Buy Phase:** the ideal moment for buying property is the start of the recovery. This phase is characterized by:

- cyclically lower prices;
- low interest rates;
- reduced sales volume;
- high inventory levels; and
- few willing buyers.

The **Hold Phase:** the phase following the acquisition of a property during the buy phase or after a sale in the sell phase, can be the longest time period in the cycle. Prudent investors patiently bide their time after a purchase, awaiting the boom or bust to play out before reentering to buy or sell.

The **Sell Phase:** this phase commences with a peak in sales volume. It is characterized by:

- rising prices;
- a drastic fall in the yield spread;
- low inventory levels;
- high mortgage rates; and
- reductions in monthly year-over sales volume.

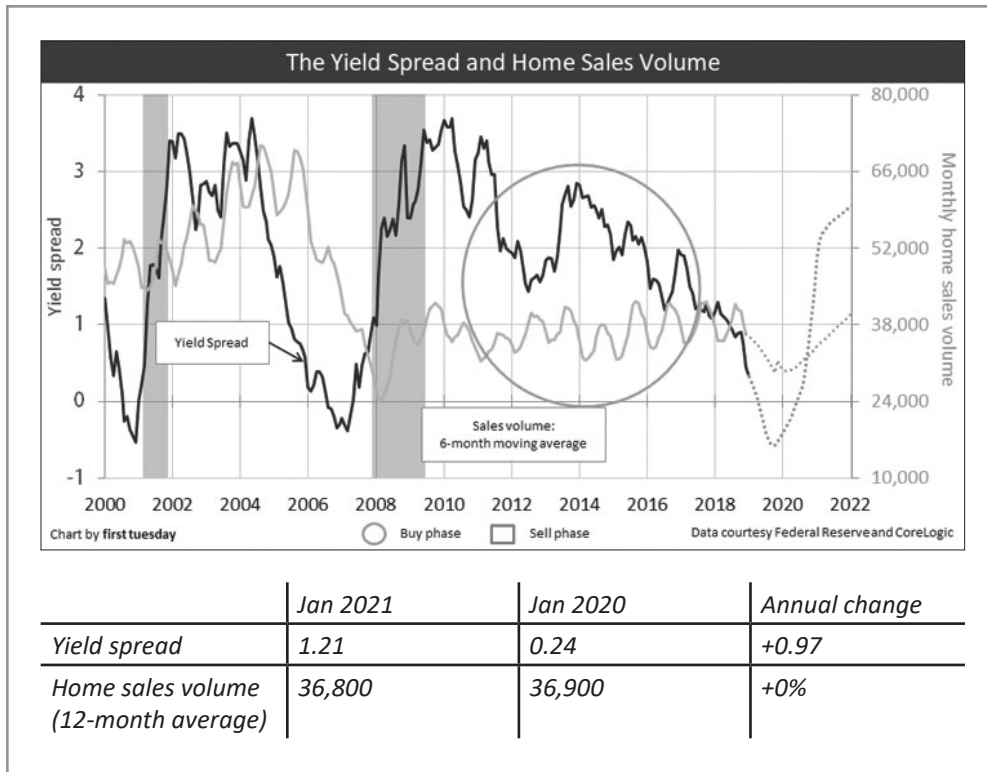


Figure 4
 The Yield Spread and Home Sales Volume

ONLINE UPDATE
 Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.

The buy and sell phases each occur just once during a real estate cycle. The hold phase appears twice: once after the buy phase, and once after the sell phase. [See Figure 4]

The key to successful real estate investing is to look beyond the property's annual operating income to the end goal: **a sale**. Whether on a quick flip or after a long-term buy-to-let period, the endgame is to maximize profit on a resale. That is, to sell at a price appreciated beyond the price paid and consumer inflation. Here, timing is the keystone supporting the purchase and sale activity, and thus is the profit.

The investor's goal

For investors to sell for a profit, they first need to buy near the bottom to midway in a market recovery half cycle — the buy phase. This is when property prices are closest to their historic mean price. [See Figure 5]

It is rarely, if ever, possible to identify the top or bottom of a market cycle until after it has already passed. However, studied effort makes it more likely.

How can prices be anticipated? Fortunately, prices are a lagging indicator of real estate activity. Several early signs indicate an approaching long-term price increase.

Anticipating prices

yield spread

The difference between the 10-year Treasury Note rate and the 3-month Treasury Bill rate, forecasting economic conditions one year forward.

The **yield spread** is the first domino in a series of movements influencing the housing market. The yield spread is the difference between the long-term (10-year) and short-term (3-month) Treasury rates. It indicates economic performance one year forward. [See Figure 4]

The yield spread directly affects home sales volume 12 months forward. Thus, if you observe movement in the yield spread, you can successfully predict the direction of future home sales volume. Six months of consistent yield spread movement is long enough to create a continuing trend.

Experience shows us that sales volume pace will follow in the same up or down direction 12 months after the yield spread trend began. Until it reverses course to run with the yield spread, sales volume will continue on its previous upward or downward path.

In turn, home sales volume sets the level of prices another nine months forward. [See Figure 4]

The best way to demonstrate is with an example from our recent history.

1999-2002: hold phase

From 1999-2002, home sales volume declined annually even as home pricing continued its decade-long rise. The yield spread stood at an historic low, averaging 0.95 from 1999-2001. More importantly, it went negative (with short-term rates valued lower than long-term rates) for several months in early 2001. These conditions signaled an imminent recession.

When **the Federal Reserve (the Fed)** raises interest rates, their aim is to slow the market down, such as reduce the demand for employees. Concurrently, fewer loans are made, and sales volume slows within 12 months. However, the 2001 recession failed to fully materialize. As a result, the recession was unable to work its magic to cool the economy (and real estate prices) since the Fed prematurely bolstered the economy after September 11, 2001.

When the economy is deliberately slowed and delivers mixed signals, prudent investors hold onto their cash and their property. They neither buy nor sell.

2002-2004: buy phase

After a recession and when the yield spread has increased for a period of roughly six months, investors are to prepare for the beginning of a buy phase. Preparation includes researching location – where and what type of property the investor will buy – and price – how much they will pay.

The actual time to buy? Once the yield spread begins to waver at its peak, as in late 2001/early 2002. As can be seen in Chart 2, 2002 demonstrated upward price movement above the 2001 trough, increasing to a price peak in 2005. After that, prices slipped, then plunged.

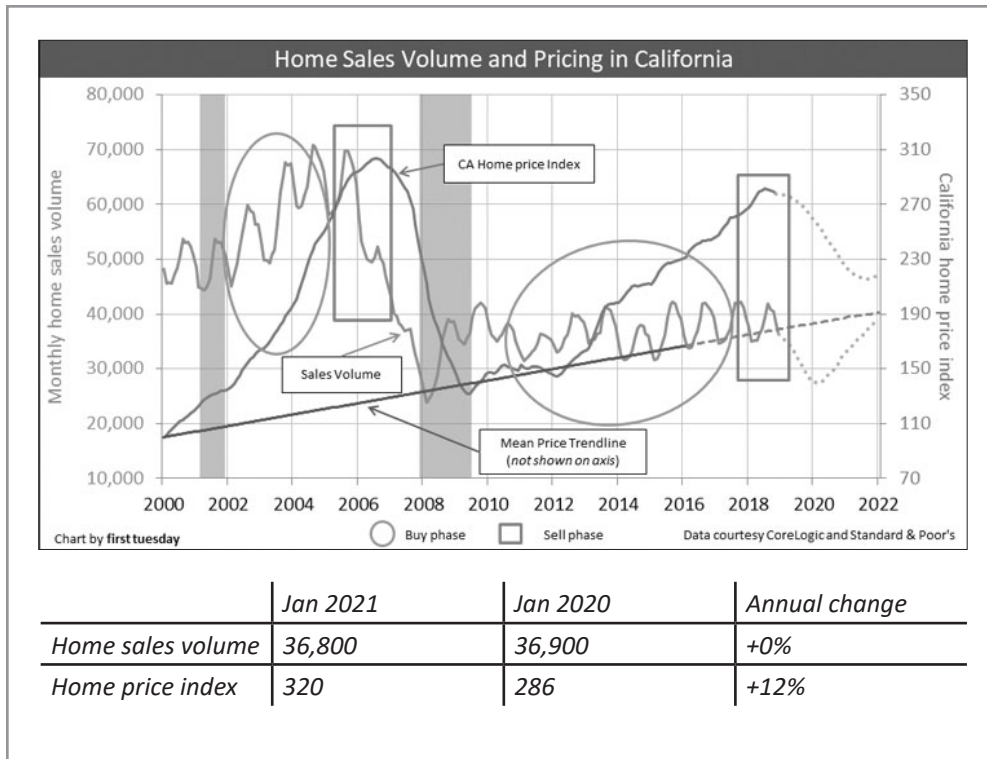


Figure 5
Home Sales Volume and Pricing in California

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

The buy phase continued from 2002 through 2004. Preferably, an investor would have bought early in 2002 and waited until 2005 to sell. This waiting game is strategic — wait too long and you may lose money. Or, sell too soon and you may receive less than the maximum **return on investment (ROI)**.

When prices have risen sufficiently for you to meet your profit goals and the economy is delivering signals that the buy period is ending, sell. Sell periods are the shortest, quickest phases of the cycle.

2005-2006: sell phase

The briefness of the sell phase is due to public pessimism. The general public is slow to trust the market (causing slowly rising prices) and quick to get out at the slightest hint of falling prices (causing a sharp price drop). Therefore, one ignores the signs of a sell phase at one's peril: it will be over just as soon as it began.

When sales volume starts to drop, real estate prices continue to increase for about nine months. Prices rise beyond sustainable demand and sales volume declines further.

In 2005, both the peaks and low points for monthly home sales volume were lower than the previous year's, the presage of a price drop nine months forward. This slip in home sales volume is the **clearest indicator** the sell phase is ending.

In 2006-2007, the price dropped abruptly, further accelerating within a matter of months. The time for selling preceding a price drop is marked by

general optimism about ever-increasing prices. New buyers arrive every day, but in fewer numbers, still expecting unlimited profits on a resale. These late-arrival optimists are unaware of the quicksand beneath their feet.

A savvy investor can see the dramatic fall in home prices coming even before sales volume decreases. As soon as the Fed increases short-term interest rates for 6 months continuously, investors must prepare themselves to sell.

The Fed began raising rates in August of 2004. The yield spread began its precipitous fall just ten months later. It then dipped below the 1.21 spread which portends a recession some 12 months on. On schedule, the upward home sales volume reversed in mid-2005. Nine months later in 2006, again on schedule, home prices peaked and began their nosedive.

When selling is the short-term goal, sellers must be ready to list as sales volume begins to flag. Investigating price levels for comparable properties determines an appropriate listing price, and the acceptable sale price. Equally important, an investor uses this time to locate a broker or agent who will aggressively market the property, locate a buyer and close escrow.

Real estate is local

Of course, this theme has variations. Real estate demand is highly localized. Thus, a thorough knowledge of local economics is necessary to accurately pinpoint the real estate phases. [See Factor 25: Regional housing indicators]

Even when the yield spread is continuously increasing, pockets of high **loan-to-value ratio (LTV)** mortgage debt and low-income buyers may blunt any future stable price increases. There just isn't sufficient buyer-occupant demand. This situation is currently observed in Riverside, San Bernardino and much of the Central Valley, though driverless vehicles for commuting are likely to put end to that.

Likewise, regional employment levels can either escalate or kill the profit-making aspects of a buy phase. After all, employment is the basis for a buyer's ability to take out a mortgage and create demand for real estate. Thus, suburban locations have their own **demand** issues separate from coastal areas, where job opportunities are most abundant. [See Factor 1: Jobs]

When employment is rising but prices remain low, it is time to prepare for a buy phase.

This is the time to:

- canvass your region and categorize local **inventory**.
- select where to buy, whom to work with and what type of properties to purchase (size, valuation-rent);
- investigate the local lenders and their rates, including getting pre-approved by multiple lenders; and

consider short- and long-term ownership objectives, including what type of property (multi-family, SFR, vacation home, etc.) will meet your goals.

inventory

Properties available on the market for sale through the multiple listing service (MLS).

It must be emphasized, of course, that it is ultimately impossible to determine the absolute best moment to take advantage of an economic boom – to sell; or crisis – to buy. Those moments only become realized in hindsight. In this copy, we have identified historical moments of opportunity for the reader’s consideration. However, our forecasted ideal times to sell and buy are only informed opinions, sometimes jokingly referred to as educated guesses. Facts and data can only be derived from the past as they have been experienced.

The actual decision of whether to buy or not depends not only on the economy — which is highly localized — but also on the specific homebuyer, and the seller’s willingness to carry paper.

2021 and the following few years will not be times of untrammelled get-rich-quick investment opportunities. Nonetheless, if you have an eye for long-term market stability in real estate prices, you will be rewarded.

Risk of opportunities lost

Our economy moves in cycles, called business cycles. The length of a cycle is never set or reflective of the number of years experienced in past cycles. The length is determined by the extent and duration of economic excesses and recesses and government monetary and fiscal responses during the cycle as well as foreign economies.

It is rarely, if ever, possible to identify the top or bottom of a market cycle until after it has already passed. However, studied effort makes it more likely.

How can prices be anticipated? Fortunately, prices are a lagging indicator of real estate activity. Several early signs indicate an approaching price increase and thus the beginning of a buy phase.

The yield spread is the first domino in a series of movements influencing the housing market. Sales volume will follow in the same direction 12 months after the yield spread trend began. In turn, home sales volume movement sets the level of prices another 9-12 months forward.

buy phase pg. 26
end user pg. 25
hold phase pg. 26
inventory pg. 30
sell phase pg. 26
yield spread pg. 28

Chapter 2.4 Summary

Chapter 2.4 Key Terms

Chapter 2.5

Buyer purchasing power determines home prices

Learning Objectives

After reading this chapter, you will be able to:

- understand the relationship between interest rate drops and greater buyer purchasing power;
- discuss the correlation between interest rate increases and diminished buyer purchasing power; and
- understand the relationship between buyer purchasing power and home prices.

Key Terms

- buyer purchasing power**
- dead cat bounce**
- debt-to-income ratio (DTI)**
- sticky pricing**
- teaser rate**

The driving force of real estate pricing

Buyer purchasing power is the driving force behind real estate pricing. On one side of the scale sits the buyer with money. On the other is the seller with a property. Between them sits the all-powerful lender which is funding the transaction.

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.

Figure 6 displays the *Buyer Purchasing Power Index*. This index measures the year-over-year change in the amount of mortgage money available to a buyer based on average gross income. It varies based on the interest rate charged for a 30-year fixed rate mortgage (FRM). [See Figure 6]

An index of zero translates to no year-over-year change in the amount one can borrow. A positive index number, say 5, means the buyer can borrow 5% more money this year than one year earlier. The index is based on today's incomes.

Finally, a negative index figure translates to a reduced amount of mortgage funds available compared to one year earlier.

30-year FRM rate and mortgage funds available

Figure 7 contrasts the average 30-year FRM rate with the corresponding mortgage funds available, in today's dollars. From the 1980s through 2012, interest rates generally decreased, resulting in more funds available to buyers each year. Since then, mortgage rates have generally increased. Figure 7 also includes a comparison of the buyer purchasing power index and home prices. [See Figure 7]

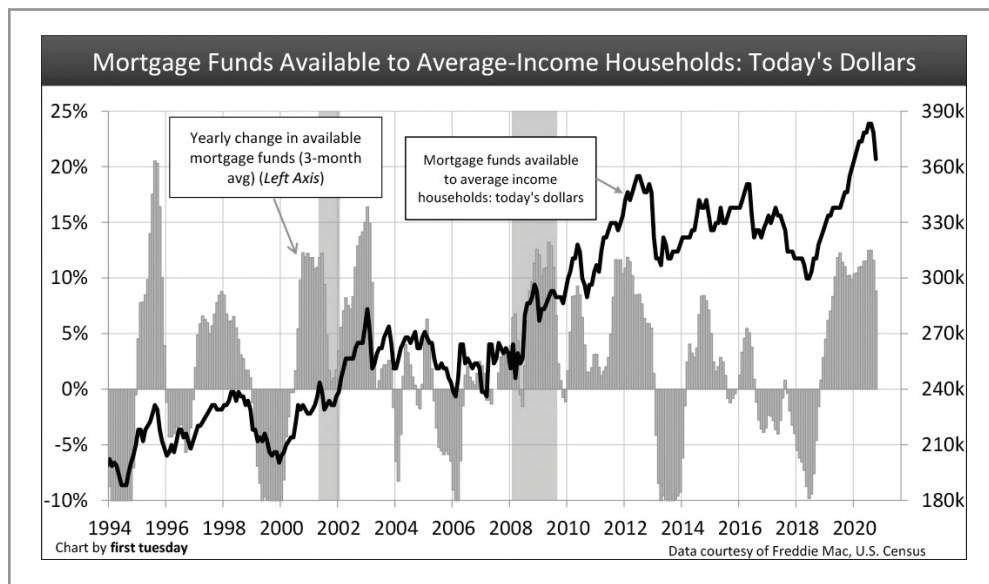


Figure 6

Mortgage Funds Available to an Average Income Household: Today's Dollars



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Looking forward, fixed rate mortgage (FRM) rates will likely remain near the relatively low levels of 2021 through 2023. That's because the Fed has indicated it will hold off on further rate increases while the economy reaches a period of recovery. However, as the Fed begins their **bond taper** by reducing their mortgage-backed bond purchases, interest rates have begun to inch higher heading into 2022. These rate increases will pick up speed with the economic recovery, likely to gain momentum around 2023-2024. [See Factor 19: Wealth from other nations]

As interest rates increase, buyer *purchasing power* will decrease, offset only by an annual increase in wages.


Figure 7 displays how falling interest rates increased the mortgage funds available for buyers from the 1980s, through 2012-2014. As interest rates rise over the next 20-30 years, this principle will work in reverse. Mortgage funds available to buyers will decrease. However, the astute reader will notice that the amount of available mortgage money, measured in today's dollars, flat-lines after 2020.

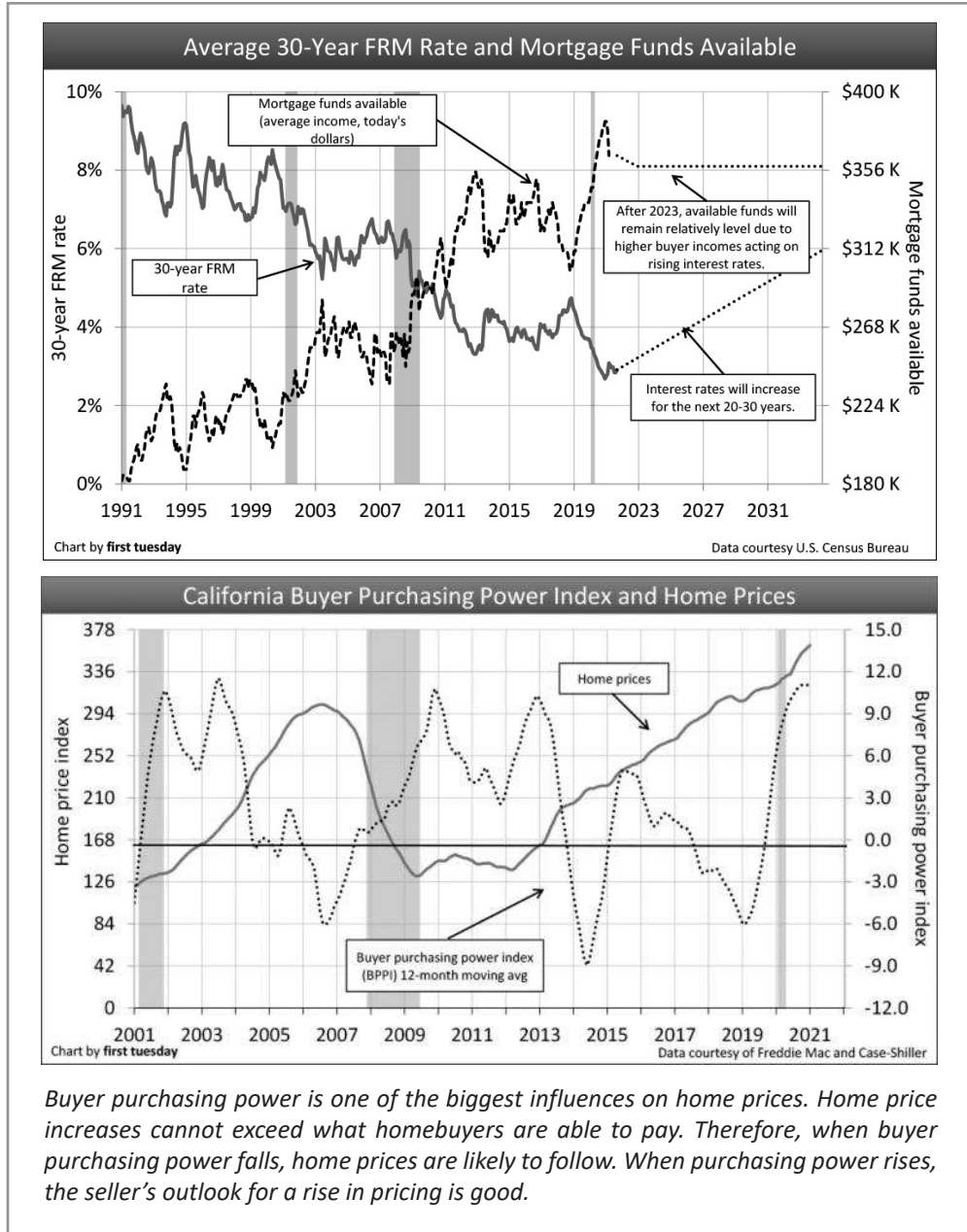
Several factors push and pull on buyer purchasing power to create this post-2024 plateau trend:

- Population growth in California's urban cores will create economic support for the state's economy.
- A buoyed economy will lead to higher median incomes, meaning buyers will have more money to spend.
- As buyers with more money flood the market, home sale prices will increase.
- Increased income will be countered by rising mortgage rates.

Mortgage funds decrease in availability

Figure 7
Average 30-Year FRM Rate and Mortgage Funds Available
and
California Buyer Purchasing Power Index and Home Prices


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



Together, increased income and rising interest rates will level out buyer purchasing power. Read on to learn about how interest rate movements influence pricing. This knowledge will help you counsel your sellers and buyers.

The lender determines the buyer's mortgage amount

Each buyer has a maximum price they can pay to purchase property. This maximum price depends on:

- the buyer's down payment; and
- the mortgage funds they qualify to borrow from a lender.

The amount of mortgage funds a buyer can borrow is based on two factors:

- the buyer's income, which adjusts annually at the rate of inflation; and

- current mortgage rates, which change constantly.

Lenders know buyers are less likely to default if they allocate no more than **31% of their monthly gross income** to their monthly mortgage payment. Accordingly, mortgage lenders refuse (as mandated) to lend more money than the buyer can repay at that 31% gross income ratio, amortized over 30 years.

On the other hand, sellers seek the highest possible sales price they can get from a buyer. The sales price of all homes sold within each pricing tier cannot on average exceed the purchasing power of buyers shopping in that tier.

When all sellers within a tier hold out for above-market prices, buyers for that tier of property eventually will not be able to buy. Thus, buyers control the price sellers will receive, based mostly on mortgage funds available at current interest rates.

Figure 6 illustrates that sellers have received greater and greater prices over the past 20 years driven primarily by a continuous drop in interest rates (a Fed activity called the **Greenspan put**). However, the pricing trend will reverse moving out of the zero lower bound interest rate regime we left in 2015. And the downward pressure on prices will continue for a long time as interest rates are unable to drop for the next couple of decades — except temporarily during Fed engineered business recessions.

Rates hovered near zero from 2009-2015 and again beginning in 2020 — and while a rate of zero was too high to stimulate the economy, the Federal Reserve (unlike some countries) was unwilling to go negative. Expect rates to rise over the next 30 years (except during recessions). [See Factor 8: Inflation & CPI]

The maximum amount mortgage lenders will lend a qualified buyer depends on current mortgage rates. As mortgage rates rise, the maximum price a buyer can pay for a home declines since the amount they are able to borrow declines.

The static 31% **debt-to-income ratio (DTI)** is set for buyers needing a mortgage. Going forward, buyer income will rise annually based on consumer inflation of around 2%. This inflation figure has been typical for nearly two decades, though wages have not kept up with consumer inflation much less asset inflation (think homes) over the past 15 years.

As interest rates rise, the interest portion for the same monthly amount of payment on a new mortgage increases. The result is a reduction in the portion of each payment that goes toward amortizing mortgage principal. In turn and critically, the amount of principal the same monthly payment will amortize is smaller. The smaller the principal mortgage amount the buyer can borrow, the less price sellers can get from buyers. It is axiomatic.

Buyers control the seller's price

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.

Reading the charts

The mortgage funds available to a buyer from year to year are depicted by the solid line on Figure 6. These amounts are in today's dollars and are based on the mortgage amount an average income earner in California qualifies to borrow. Payments are set at 31% of gross income (before withholdings).

What appears is a purchasing power change of roughly \$90,000 in amounts borrowed with the same income over the past 20 years — due solely to interest rate reductions.

Consider California's average monthly household income of \$5,016. At 31% of this monthly income, the maximum mortgage (and principal, interest, taxes and any impounds (PITI)) payment the average homebuyer with less than 20% downpayment can qualify for is \$1,155. This amount includes PITI the buyer pays to the bank.

Thus, the amount of money available monthly to repay the mortgage for a new home (the principal payment) changes from week to week as interest rates rise and fall. The rates used on the charts are for a 30-year fixed-rate mortgage (FRM).

The yearly change in available mortgage funds (shaded bars) on Figure 6 depicts the percentage change in mortgage funds available compared to one year earlier. Mortgage funding changes in amount as interest rates rise and fall. The higher the shaded bar, the higher the mortgage amount a buyer will qualify for compared to the previous year using today's pay.

Figure 6: Historical examples

The significance of the one-year rate differential can be seen on Figure 6 in the following historical examples:

1. **2003:** Mortgage rates were too low during this period, an aberration in rates due to the Fed's overreaction to the 9/11 attacks. The Fed kept rates low, instead of allowing the 2001 recession to work its price-reduction magic. Due to lower rates, buyers were able to borrow much more than they were able to a year or two earlier.

This led to a spike in buyer purchasing power. Sellers and their agents recognized the increase in mortgage amounts buyers qualified to borrow, and began demanding higher prices. Add to this math the *financial accelerator effect* of ever larger mortgage amounts from all types of lenders on home resale prices. Thus, lenders accepted these homes as collateral at ever greater valuations artificially driven further up by nothing more than increased mortgage amounts. Lenders foolishly accepted that condition.

2. **2004 and beginning of 2005:** FRM rates flattened, causing buyer purchasing power to stabilize. However, property prices were rising. To compensate for this mixed price/lending condition, lenders, homebuyers and speculators resorted en masse to **adjustable rate mortgages (ARMs)**. ARMs allowed lenders to mask the amount of future payments with low up-front rates, called **teaser rates**, and interest only payments (or less as with negative amortization). With ARMs, the borrower qualifies for greater mortgage amounts than

teaser rate

A temporary, low introductory interest rate found in adjustable rate mortgages.

available by taking out an FRM. However, when those teaser rates adjust upwards, the borrower cannot repay at the higher interest rate, and sells or defaults.

3. **Mid-2005:** Sales volume reached its peak while prices continued to rise. The diminishing numbers of buyers turned to option ARMs and alternative A-paper mortgages (Alt-As), also called **liar loans**, to meet the prices sought by sellers.
4. **2006:** Sales prices peaked early in the year. Home prices began a decline from their artificially inflated status. Buyers and their agents began setting prices by applying fundamentals related to the real world as competitive bidding disappeared. These fundamentals factored in the replacement cost of land and improvements, and the income approach for setting value. As prices declined, **speculators** temporarily slipped away from participating in the market, except to dump property and recover cash.
5. **2009:** The Fed lowered interest rates essentially to zero. The rise in buyer purchasing power seen in 2009 and government stimulus produced the classic **dead cat bounce** inherent in all recessionary drops. Due to the Great Recession and financial crisis, mortgage rates were dramatically lowered by the lender of last resort — the Fed — as they indirectly via the bond market funded all newly originated home mortgages for the next few years.

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.

This Fed activity provided all the mortgage financing needed by buyers with down payments as little as 3.5%. Governments provided subsidies to stimulate buyers until mid-2010. Unfortunately, reduced rates and down payment amounts also attracted troublesome speculators as flippers. All this again drove prices of low-tier housing up to unsustainable levels going into 2010.

The FHA contributed to this mini-frenzy by eliminating the 90-day investor holding period through 2014. Flipper activity increased rapidly, interfering with the organic sales recovery at the expense of sellers, homebuyers and the real estate market.

Consider a buyer whose gross annual income (\$58,000) allows them to make a monthly payment of \$1,500.

The \$1,500 monthly payment qualifies them for the following mortgage amounts on an FRM:

4%: \$314,000	6%: \$250,000
4.5%: \$295,800	6.5%: \$237,100
5%: \$279,200	7%: \$225,300
5.5%: \$264,000	7.5%: \$214,400

If the interest rate fluctuates so much as half a percentage point, the mortgage amount changes by thousands. All buyers are subject to the same relative

Little rate changes make a big difference

reduction in their mortgages on a rate increase. Thus, sellers as a whole need to accept a lesser price if they are to sell and the market maintain the same pace of sales volume that existed prior to the rate hike.

Sellers' sticky price delusion

sticky pricing

A seller's irrational reliance on past home pricing as a basis for setting current pricing, called the money illusion.

Other factors weigh in to change the dynamics of this formula. Sellers, by nature, are culturally susceptible to the age-old real estate phenomenon of **sticky prices** during recessionary periods. Sellers generally are uninformed about pricing properties in the real estate market. Instead, they believe that they need to get more for their property than the neighbor did down the street, whether it sold last year or the year before.

This *sticky price* phenomenon leads to a seller's delayed response in properly pricing their property to keep pace with the market. As a result, when mortgage rates rise, the real estate market moves toward a stand-still. Soon, sellers and their agents figure out prices need to be dropped to sell and return sales volume to its norm.

Sticky pricing in application

Consider a buyer who is interested in acquiring a particular home. A year earlier, the buyer qualified to borrow sufficient funds to pay the seller's price. However, mortgage rates have risen and the buyer is now unable to borrow the same amount of money.

Unsurprisingly, the property the buyer was able to buy just a few months ago is now priced out of reach due to the interest rate change, not an increase in the price. The buyer now only qualifies to purchase the property at a lower price.

However, as is usually the case, the buyer is not interested in purchasing a lesser property than the one they once were qualified to buy. Buyers will rarely downgrade. If they previously qualified for a mortgage large enough to purchase one home, they tend not to purchase a lower-grade home. They will instead wait until prices or interest rates drop, or their income significantly increases.

Interest rates will rise during the next few decades. In turn, seller's prices will need to drop, if they are asking more than the equivalent rise in annual consumer inflation.

The agent's initial solution for keeping their sales volume from dropping is to change the seller's price to accommodate the mortgage rate change. If not, buyers and sellers will stand still with no ability to make a deal.

The buyer's position is static like the condition of a fulcrum about which other dynamics take place. The maximum price a buyer can pay for a property is dictated by 31% of their gross income. Likewise, lender mortgage rates are controlled by the bond market which dictates mortgage rates. So who has to give? Buyers can't, lenders won't. So sellers alone need to adjust by asking the "going price" if their intention is to sell in the current market.

When the seller does not adjust their price expectations, they must exit the market.

Each buyer has a maximum price they can pay to purchase property. This maximum price depends on:

- the buyer’s down payment; and
- the mortgage funds they qualify to borrow from a lender.

The amount of mortgage funds a buyer can borrow is based on two factors:

- the buyer’s income, which adjusts annually at the rate of inflation; and
- current mortgage rates, which change constantly.

The maximum amount mortgage lenders will lend a qualified buyer depends on current mortgage rates. As mortgage rates rise, the maximum price a buyer can pay for a home declines since the amount they are able to borrow declines.

As interest rates rise, the interest portion for the same monthly amount of payment on a new mortgage increases. The result is a reduction in the portion of each payment that goes toward amortizing mortgage principal. In turn and critically, the amount of principal the same monthly payment will amortize is smaller. The smaller the principal mortgage amount the buyer can borrow, the less price sellers can get from buyers.

buyer purchasing power pg. 32
dead cat bounce pg. 37
debt-to-income ratio (DTI) pg. 35
sticky pricing pg. 38
teaser rate pg. 36

Chapter 2.5 Summary

Chapter 2.5 Key Terms

Chapter 2.6

The influence of Federal Reserve policies

Learning Objectives

After reading this chapter, you will be able to:

- explain the crucial interest rates commonly used in California real estate transactions; and
- understand how the Federal Reserve controls short-term interest rates.

Key Terms

1-year Treasury Bill

discount rate

applicable federal rates (AFR)

federal funds

Cost of Funds Index

prime rate

The discount rate at work

discount rate

The interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.

Minimum reserve requirements are imposed on banks to prevent a crisis of liquidity. As an additional measure to ensure the supply of money from banks to the public, the **Federal Reserve (the Fed)** makes loans to banks to fulfill its role as lender of last resort. [See Factor 17: Monetary policy]

The **discount rate** is the interest rate the Fed charges banks and thrifts for funds borrowed directly from the Fed to maintain reserve requirements when funds are unavailable from private banks with excess reserves.

The *discount rate* is important to private money lenders, when they:

- are not licensed real estate brokers; and
- do not arrange their mortgages through real estate brokers.

Nonetheless, an understanding of discount rates is beneficial to real estate brokers and agents. Most importantly, the discount rate is a component of the interest rate limits imposed by usury laws on non-brokered, private money mortgages, since they are not exempt (as are all broker-made or broker-arranged mortgages).

The discount rate component for usury limits is set each month based on the *Federal Reserve Bank of San Francisco (FRBSF)* discount rate effective on the 25th day of the month previous to the month the mortgage is agreed to by the lender. The discount rate is set for the life of the non-exempt mortgage.

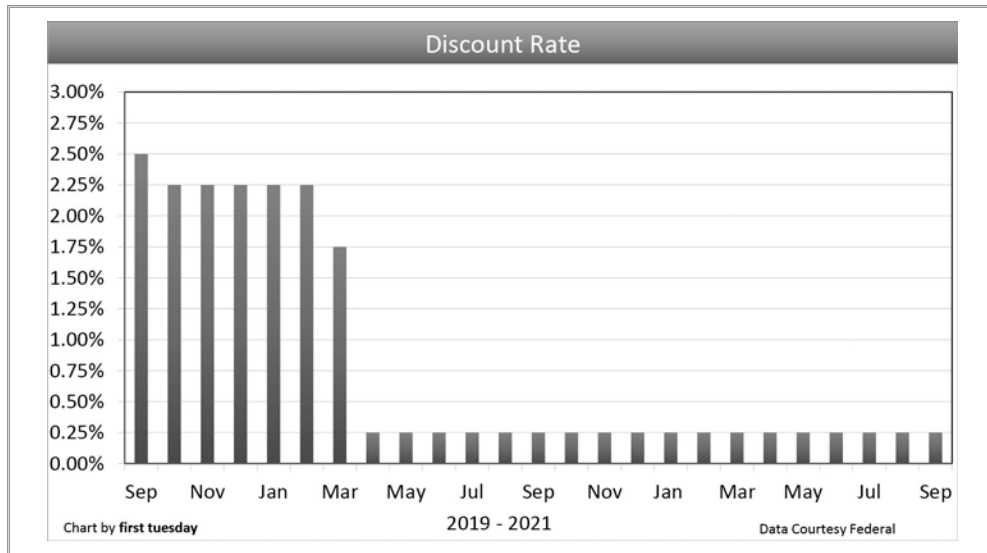


Figure 8
Discount Rate

The maximum annual interest rate on non-exempt mortgages is the greater of:

- 10% per annum; or
- the discount rate plus 5%.¹ [See Figure 8]

Depending upon current rates, banks often prefer to borrow from one another rather than the Fed. **Federal funds** are overnight funds lent by other banks with excess reserves and the Fed in the open market to banks with insufficient reserves.

The Fed influences the movement of the federal funds rate by buying or selling government securities, typically **1-year Treasury bills** (T-Bills). This raises or lowers the supply of bank reserves available in sympathy with the Fed buying and selling securities.

When the Fed wants to tighten monetary policy to reduce the rate of inflation, it will sell government securities it holds. This withdraws funds held by investors and thus reduces bank reserves. This tightening is the result of an increase in the Federal funds rate set by the Fed's sale of securities to take cash out of the economy.

An increase in the Federal funds rate directly causes rate increases in other short-term money instruments such as T-bills, certificates of deposits (CDs) and repurchase agreements (RPs). In the real estate market, movement in the federal funds rate influences movements in adjustable rate mortgage (ARM) indices. In turn, this triggers adjustments in the note rate and payment schedules for ARMs.

Fixed-rate mortgages (FRMs) are not affected by the Federal funds rate since they are tied to 10-year Treasury notes.

Federal funds

federal funds


Overnight funds lent to banks with insufficient reserves by the Federal Reserve and other banks with excess reserves.

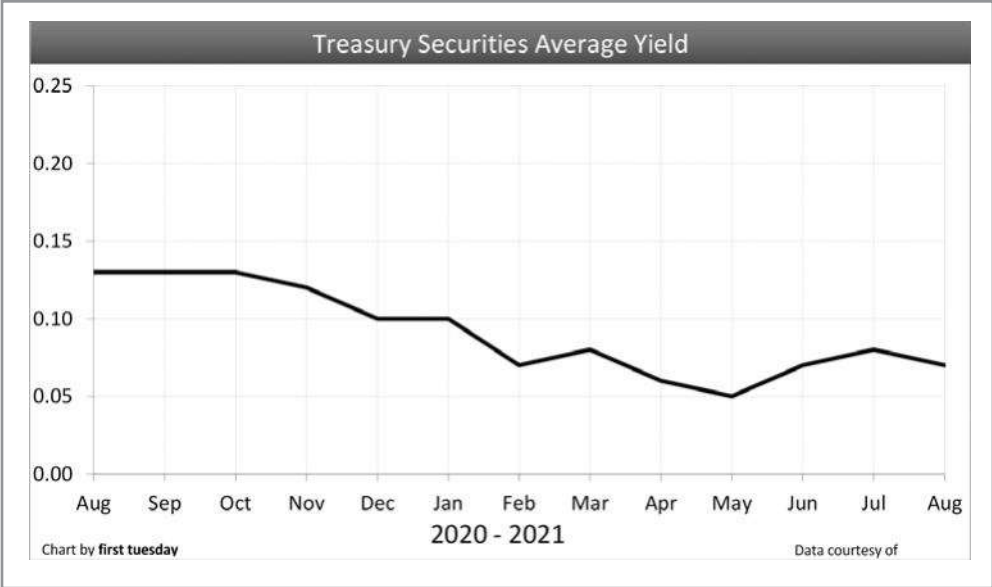
1-year Treasury Bill

One of several indices referenced by lenders to adjust the rate of an adjustable rate mortgage. This index is one of the most volatile.

¹ California Constitution, Article XV §1

Figure 9
Treasury Securities Average Yield


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The Fed uses the discount rate and the Federal funds rate to control short-term interest rates. Increases in short-term rates are spurred by the Fed’s perception that higher consumer price inflation looms in the future due to an excessive demand for goods and services. [See Factor 8: Inflation & CPI.]

By increasing the short-term rates, the Fed raises the cost of borrowing by businesses, governments and buyers of cars and appliances, limiting the availability of credit. This slows the economy down, decreasing the level of price inflation and slowing job growth.

Treasury Securities average yield

This index is one of several indices used by lenders as referenced in their ARM note to periodically adjust the note’s interest rate. The ARM interest rate equals the T-Bill yield, plus the lender’s profit margin which is also set forth in the note. The index is an average of T-Bill yields with maturities adjusted to one year. [See Figure 9]

11th district Cost of Funds Index (for the Federal Home Loan Bank of San Francisco)

This index is another one of several indices referenced by lenders in their ARM note to periodically adjust the note’s interest rate. The ARM interest rate equals the **Cost of Funds Index**, plus the lender’s profit margin. [See Figure 10]

The figures for 1-year T-bill indices (Figure 9) are based on the sale of T-bills through the money market. In contrast, the 11th District Cost of Funds Index (Figure 10) is the average interest rate paid by thrift institutions that borrow money in the 11th Home Loan Bank District, which includes California and surrounding states. Both the 1-year T-bills and the 11th District Cost of Funds Index are used to periodically set ARM rates. [See Figure 10]

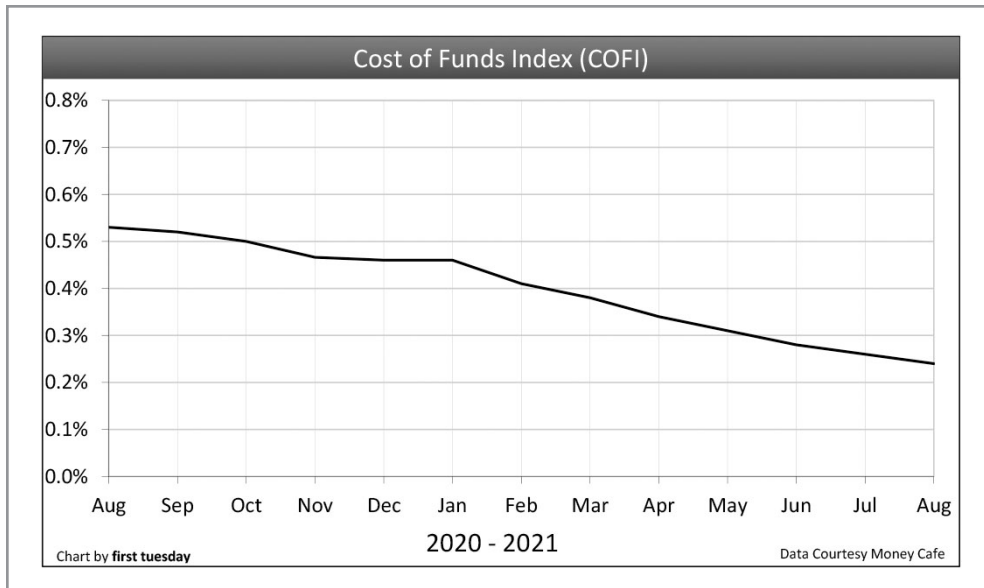


Figure 10

Cost of Funds Index (COFI)

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Rates on 1-year T-bills are more volatile and rise and fall faster than the steadier 11th District Cost of Funds. Remember that banks are able to borrow from the Fed as the primary lender at rates designed to protect their solvency during recessionary times and fight inflation during boom times.

As a result, 1-year T-Bill based indices and rates (and thus ARM rates) are prone to fluctuate wildly as the economy cycles. Although ARMs set to the comparatively stable Cost of Funds rate (which are few today) can evince less movement, the volatility of both indices makes the ARM a very risky mortgage for wage earners when used to fund the purchase or refinance of a home.

When entering periods of increasing rates, such as 2005-2007 and 2016-2018, lenders who retain the mortgages they originate prefer the faster upward movement of the 1-year T-bill indices for increasing their yield, maintaining portfolio value and remaining solvent.

The **prime offer rate** index is one of several referenced by lenders in their ARM note by adding a margin of 2% or 3% for monthly adjustments in interest charges. The prime rate is set in unison by U.S. banks, and is adjusted as frequently as the Fed adjusts the federal funds rate. [See Figure 11]

Borrowers with high credit scores may have their interest set to a lower rate, such as the London Inter-Bank Offered Rate (LIBOR). [See Figure 21]

The prime offer rate is a base rate used by banks to price short-term business loans, and is set at 3% above the federal funds rate. As short-term interest rates increase, so does the prime rate. In addition to ARMs, home equity lines of credit, credit card rates and some private student loans are commonly indexed to the prime rate.

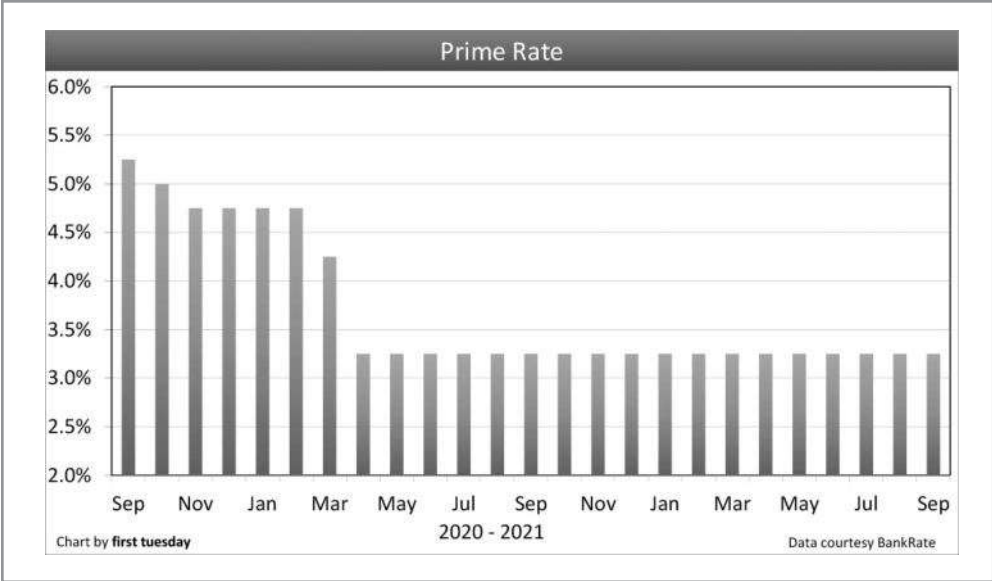
Cost of Funds Index

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.

Prime rate**prime rate**

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.

Figure 11
Prime Rate



CPI, rents and resale pricing

The long-term interest rates reported in this chapter are:

- the average 30-year conventional commitment rate for the Western region as reported by Freddie Mac; and
- 10-year T-bills.

The Fed infrequently takes direct control over long-term interest rates. The Fed did so during 2009 and 2010, and again in 2011-2012 due to the jobless recovery following the 2008 recession.

However, the Fed controls **inflation** primarily through its monetary policy. By moving the short-term rates the Fed influence the expected future inflation rates. The bond market’s expected rate of inflation going forward is reflected in its long-term interest rates. [See Factor 17: Monetary policy]

For example, the Fed began to increase short-term interest rates in mid-2004 and continued through 2005. The Fed did this to fight perceived inflationary pressures in the economy brought about by demand for employees and pricing (and the recovery of foreign markets, weakening dollar, etc.).

Due to a general view within the bond market that inflationary pressures existed in the national economy, and controversy over whether the Fed had the desire or tenacity to control the perceived inflationary pressures, long-term interest rates began to rise.

applicable federal rate (AFR)
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.

Applicable federal rates

Applicable federal rates (AFRs) determine the minimum interest yield reportable on carryback financing, called **imputed interest** since it is the obligation of the taxpayer to impute principal in the note to interest income and report and pay taxes on the income. The AFR category is determined by the carryback due date. Listed rates are for monthly payments. [See Figure 12]

Imputed interest reporting applies the AFR to debt carried back by a seller on an installment sale. An interest rate on a carryback note negotiated at a

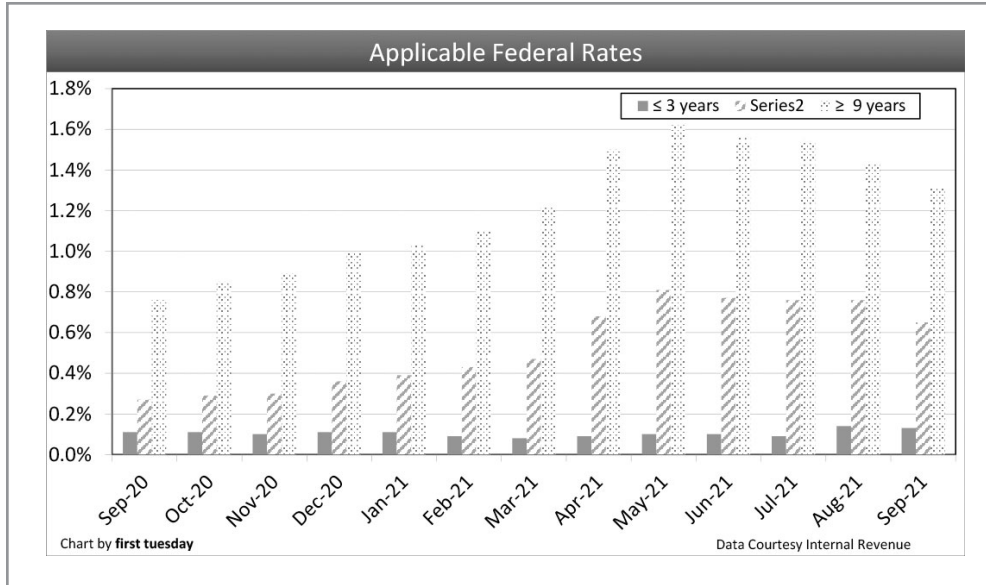


Figure 12
Applicable Federal Rates

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note rate below the AFR triggers imputed interest reporting to the Internal Revenue Service (IRS). Thus, profit in the form of principal on the note with a note rate below its Applicable Federal rate is reallocated to interest income.

The imputed rate is the lesser of the AFR for the month the purchase agreement is entered into, or 9%.

Twelve AFRs are set monthly by the IRS. The due date of the note and the periodic payment schedule determine the note’s minimum reporting rate. For example, notes due in three or less years, payable quarterly, fall into the short-term AFR category at its quarterly rate.

Minimum reserve requirements are imposed on banks to prevent a crisis of liquidity. As an additional measure to ensure the supply of money from banks to the public, the Federal Reserve (the Fed) makes loans to banks to fulfill its role as lender of last resort.

The Fed uses the discount rate and the Federal funds rate to control short-term interest rates. Increases in short-term rates are spurred by the Fed’s perception that higher consumer price inflation looms in the future due to an excessive demand for goods and services.

1-year Treasury Bill pg. 41
applicable federal rate (AFR) pg. 44
Cost of Funds Index pg. 43
discount rate pg. 40
federal funds pg. 41
prime rate pg. 43

Chapter 2.6
Summary

Chapter 2.6
Key Terms

Chapter 2.7

Assorted market rates

Learning Objectives

After reading this chapter, you will be able to:

- interpret other market rates crucial to homebuying and homeownership in California.

Key Terms

§1031 transaction

91-day Treasury Bill

91-day Treasury Bill – Average Auction Rate

91-day Treasury Bill
The rate used by sellers to impute and report interest when a seller is not paid interest on their §1031 monies.

§1031 transaction
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.

The **91-day Treasury Bill** rate is the rate used by sellers to impute and report interest when a seller is not paid interest on their §1031 monies. [See Figure 13]

A §1031 seller who is not paid a rate of interest on §1031 monies held by a facilitator (also called a §1031 trustee or qualified intermediary) for the seller's use, will report and be taxed as receiving interest at a minimum imputed rate of interest on §1031 monies generated in a deferred **§1031 transaction**.

In turn, the facilitator who holds §1031 monies without an agreement to pay the seller some rate of interest will report income in the amount of imputed interest as compensation for services rendered.

Monies held by a facilitator in a delayed *§1031 transaction* are treated as a mortgage from the seller to the facilitator unless interest is earned by the seller. The seller is now responsible for reporting interest earnings on the §1031 monies. If the seller is not to be paid interest, the seller is to impute and report interest on the amount of §1031 monies at the *91-day Treasury Bill* rate. [See Figure 13]

In turn, any actual interest earnings reported by the seller but received or retained by the facilitator, or imputed interest, are reportable by the facilitator as compensation received by the facilitator for services rendered — not interest income or profits.

Imputed interest accrues and is reported by the seller (and reported as a fee for services by the facilitator) in the year it accrues, if the delay in closing continues into the next calendar year.

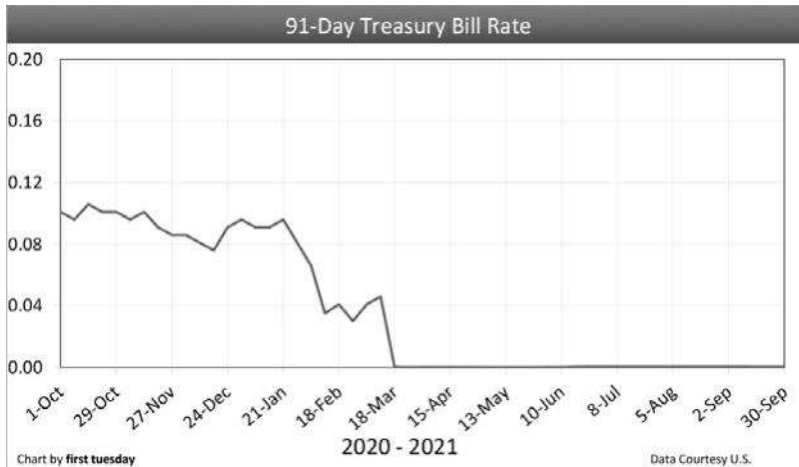


Figure 13
91-Day Treasury Bill Rate

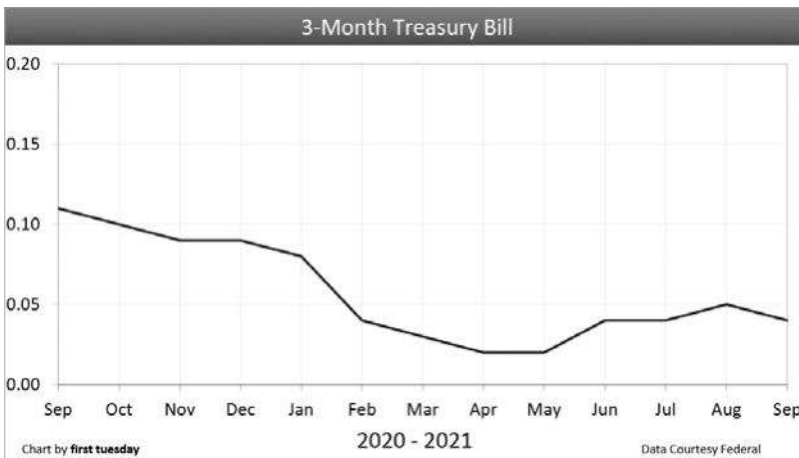


Figure 14
3-Month Treasury Bill

The 3-Month Treasury Bill is the rate managed by the Federal Reserve (the Fed) through the federal funds rate as the base price of borrowing money in the short-term. It is also used in determining the yield spread, which predicts the likelihood of a recession or rise in the economy one year forward. [See Chapter 2.3]

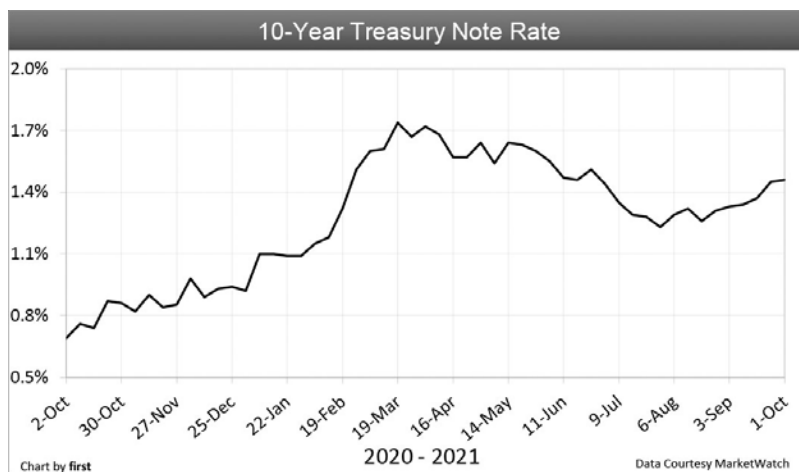



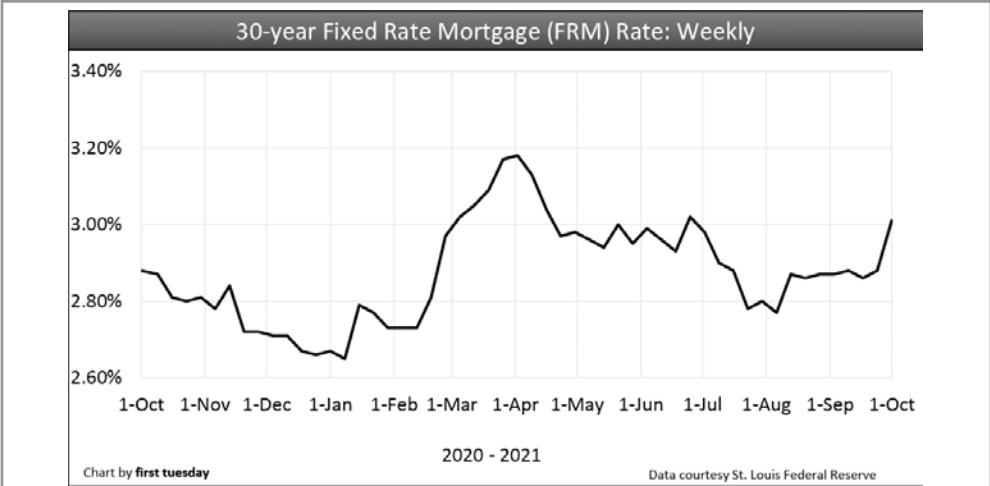
Figure 15
10-Year Treasury Note Rate

The 10-year Treasury Note rate is a leading indicator of the direction of future Fannie Mae and Freddie Mac rates, which historically run around 1.5% higher than the 10-year yield during a stable money market. The rate is comprised of the level of worldwide demand for the dollar and anticipated future domestic inflation.



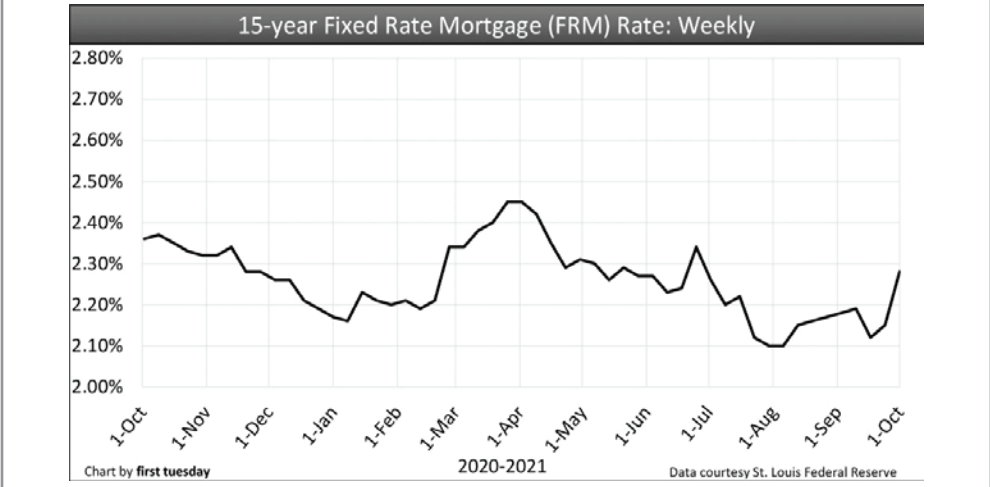
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Figure 16
Average 30-Year FRM Rate for California



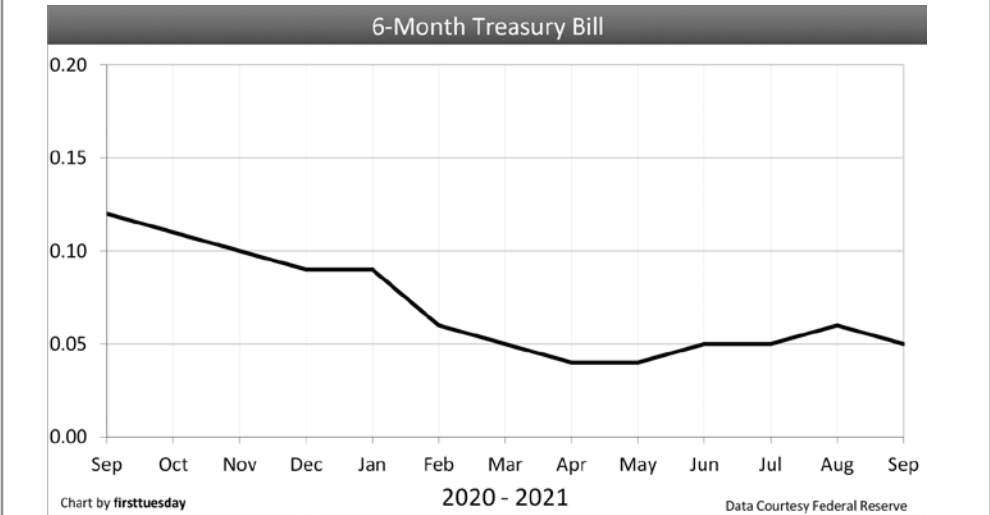
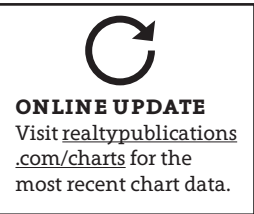
The average 30-year commitment rate is the rate at which a lender commits to lend mortgage money in the U.S.-West as reported by Freddie Mac. This rate is published on a weekly basis.

Figure 17
Average 15-Year FRM Rate for California



The average 15-year commitment rate is the rate at which a lender commits to lend mortgage money in the U.S.-West as reported by Freddie Mac.

Figure 18
6-Month Treasury Bill



The ARM interest rate equals the 6-month T-Bill rate (at time of adjustment or an average of several prior rates), plus the lender's profit margin.

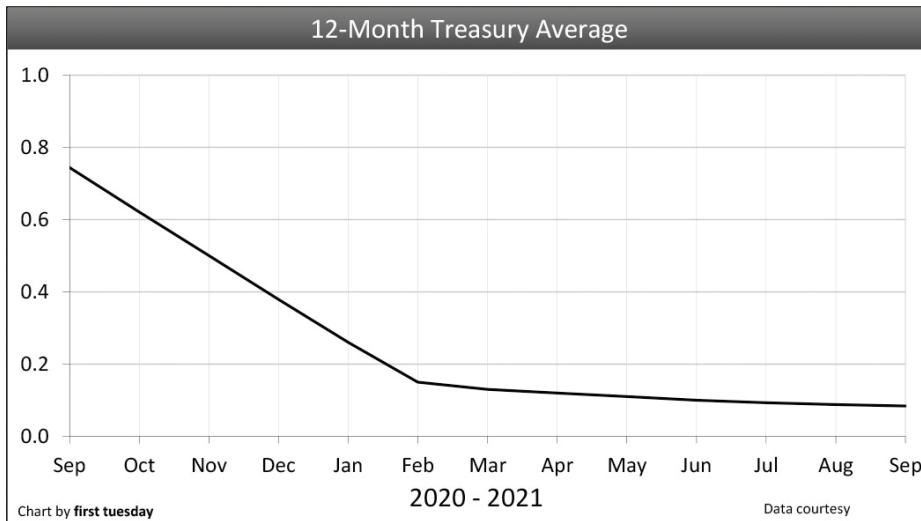


Figure 19
12-Month Treasury Average

This index is one of several indices referenced by lenders in their ARM note to periodically adjust the note's interest rate. This figure is an average of the one-year T-Bill rates for the past 12 months. The ARM interest rate equals the 12-Month Treasury Average yield plus the lender's profit margin.

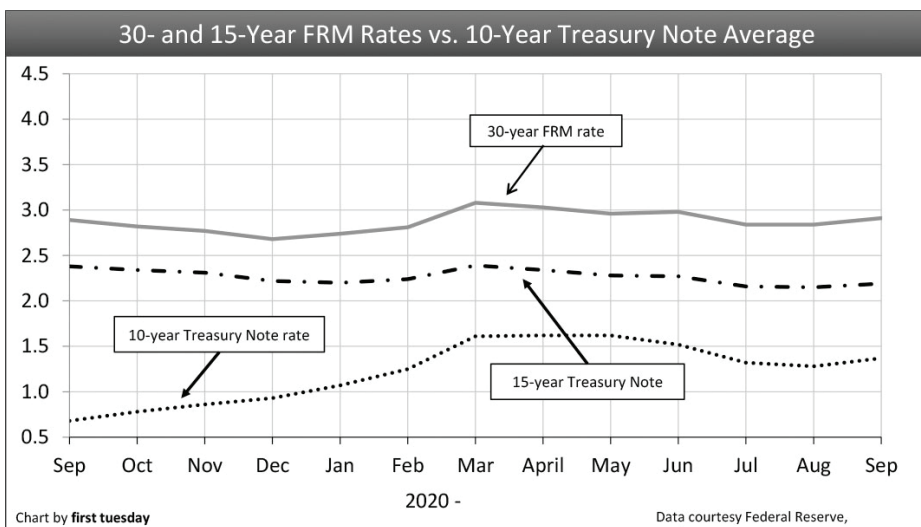
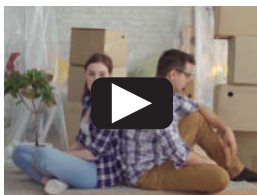


Figure 20
30- and 15-Year FRM Rates vs. 10-Year Treasury Note Average

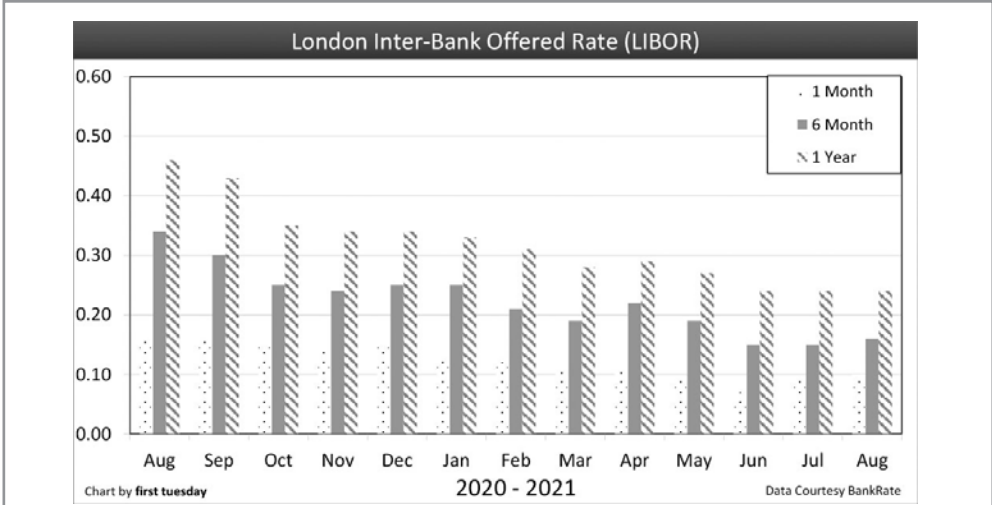
The average 15- and 30-year conventional commitment rates are the rates at which a lender commits to lend mortgage money in the U.S.-West for the duration of the life of each respective mortgage as reported by Freddie Mac. The 30-year conventional commitment rate historically runs 1.5% higher than the 10-year Treasury bill.

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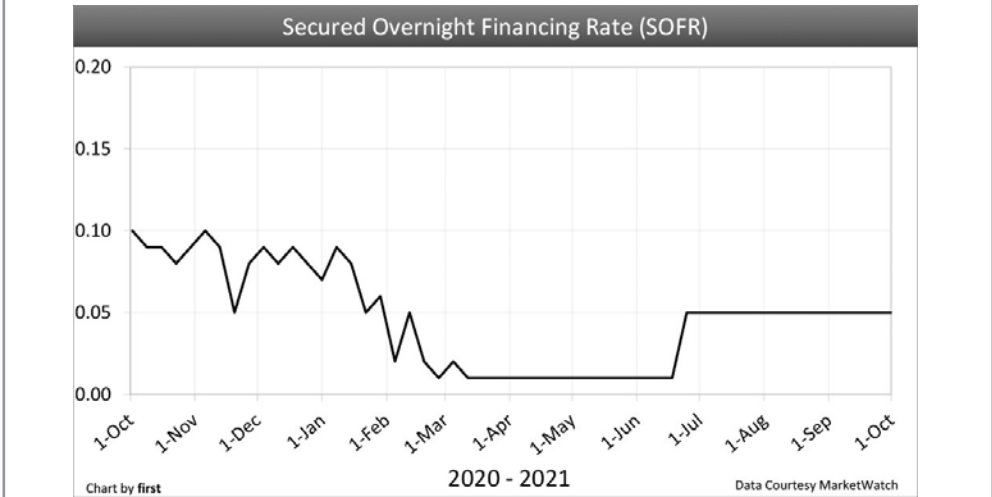
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Figure 21
London Inter-Bank Offered Rate (LIBOR)



This index is one of several indices referenced by lenders in their ARM note to periodically adjust the note's interest rate. The ARM interest rate equals the LIBOR rate plus the lender's profit margin. The rate is set by private banks in New York.

Figure 22
Secondary Overnight Financed Rate (SOFR)



This index is one of several indices used by lenders as stated in their ARM note to periodically adjust the note's interest rate. It is taking over the LIBOR in 2021, which was found to be manipulated in the years leading up to the 2008 recession and financial crisis. The ARM interest rate equals the SOFR rate plus the lender's profit margin. The rate is based on overnight borrowing in the U.S. Treasury repo market. The SOFR is produced in a transparent manner and is based on observable transactions, rather than models, and, unlike the LIBOR, is not dependent on bank estimates.

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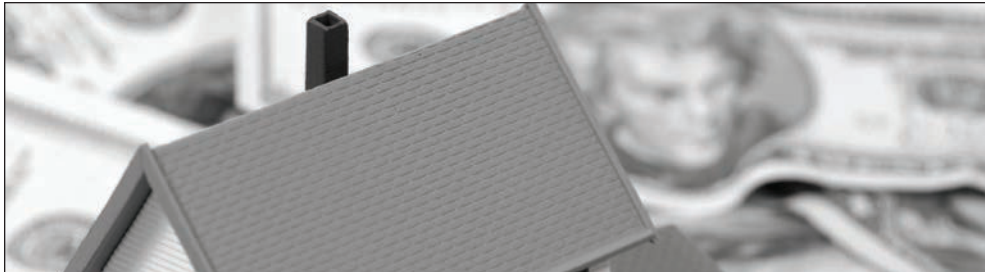
Chapter 2.7
Summary

Chapter 2.7
Key Terms

The 91-day Treasury Bill rate is the rate used by sellers to impute and report interest when a seller is not paid interest on their §1031 monies.

§1031 transaction	pg. 46
91-day Treasury Bill	pg. 46

Factor 3: Real estate speculation



The great gamble: real estate speculators decoded



After reading this chapter, you will be able to

- determine why speculators as a distinct type of real estate purchaser profit disproportionately during a recovery; and
- understand what the next speculator increase means for California's housing recovery.

appreciable asset

shadow inventory

A **real estate speculator** slips into the real estate market, sandwiching themselves between the seller and the end user homebuyer – usually a buyer-occupant or long-term *buy-to-let investor*. Their goal is to purchase the home at a discount (their belief) and sell soon after acquiring it for a juicy profit when prices inflate (their expectation).

Their gamble is to buy now on the belief prices will increase by 50% or more in two or three years. All this is a bet a profit can be had, after the cost of acquisition, *carrying costs* and the cost to sell.

Chapter 3.1

Learning Objectives

Key Terms

Why the spectacle?

Speculator transactions make up roughly 20% of all home sales in a normal, healthy housing market. During the recovery from the last recession, in mid-2013, the number inflated to 35%, decreasing to roughly 25% in 2014 and returning to normal levels of around 20% by 2016 as the economic recovery began to solidify.

Why do speculator transactions rise during times of economic recovery? To answer that, a quick history lesson on speculation is helpful.

Speculation through the ages

The history of real estate speculation in the U.S. can be traced all the way back to 18th century New England. The price of land was rising fast and investors flocked to gamble their fortunes on ever higher prices. The price bubble quickly burst (as bubbles by definition tend to do), leaving those who confidently gambled the most and got in last with nothing.

The cycle of boom and bust (and resultant speculation occurring in between) has repeated itself time and again since then. Speculation has always played a natural role in housing markets, and for good reason. When home sales volume sputters during times of economic chaos, speculators provide the much-needed support of cash providing liquidity in the market as prices drop for lack of consumer will to acquire. But the magnitude of speculation sometimes increases to the point of instability, which was the dynamic felt in California between 2013 and 2014.

The role of speculation in the Millennium Boom

The Millennium Boom was caused by a number of contributing factors. However, it was all triggered by **Wall Street Bankers** and mortgage default levels mortgage-backed bond investors never thought would come to be (as erroneously portrayed by Wall Street Rating Agencies). Everyone wanted to believe that homes were, well, golden.

Someone on Wall Street became disenchanted with day trading and decided to put some money into **mortgage-backed bonds**. Soon, Wall Street types all flocked in the same direction, funneling money into mortgages, making home financing readily available to all. This rush became a **financial accelerator**, making it easy for anyone to get a home mortgage at ever greater home prices. All they had to do was step into a bank and sign on the dotted line, with a real estate agent or builder in tow.

Government deregulation of mortgages enabled the proliferation of *no doc or liar loans* with payments hybridized and structured so everyone qualified – at the time of recording. Of course, the **Federal Reserve (the Fed)** allowed the economy to grow out of control in the first place by pumping money into the economy in late 2001 before the recession had time to work its magic to cool the economic engines.

At the same time, Congress was fast at work deregulating mortgage bankers while government administrative agencies were cutting enforcement staff.

Builders were then able to sell new homes to those hordes of families who had no down payment and could not sustain payments on the mortgages they took out.

Prior to 2008, it was common practice for builders to actually surreptitiously provide the minimum down payment required by the *Federal Housing Administration (FHA)* for an FHA-insured mortgage, and eventually conventional mortgages. These mortgages were typically called Nehemiah loans, all part of HUD deregulation from the late 1990s forced into existence by litigious home builders. 80/20 piggyback financing came into vogue allowing for no down payments.

Come 2006, buyer optimism was without ceiling, and home prices rose higher. In this year — just as prices peaked and began their steep three-year descent — 81% of surveyed consumers in Alameda County and 75% in Orange County said it was a good time to buy. They believed home prices were likely to increase, according to the Brookings Institution. It was a case of expectations of ever increasing resale volume and prices based solely on recent experiences of others, which are only fulfilled when no one is able to buy.

Consumer expectations were improperly based on the price movement of the moment (which was up). Like most, and at their peril, they ignored all other signs (such as falling home sales volume and the yield spread on bond rates) which unmistakably pointed to decreasing home prices by early 2006, with worse to follow.

And so homebuyers and lenders continued to pour wealth into the failing housing market, not knowing that they would be the last in a long line of speculators to be holding the hot potato. A monumental lack of understanding about real estate itself both generates profits for the lucky speculators and losses for those less lucky ones.

To forecast speculator activity in the years following the 2020 recession, it's useful to glance back at their presence in the recovery from the 2008 recession. Speculators gathered en masse around low-tier California homes by mid-2012 expecting finally to take profits from the recovering real estate market. Some came to the market confused, thinking hard **appreciable assets** — even gold — at whatever prices were better to hold than the U.S. dollar. They misunderstood the relationship between the Fed pumping money into the banking system during periods of zero lower bound interest rates, an overindebted population in need of deleveraging, corporations flush with cash with no need to borrow and no foreseeable consumer inflation for a decade or more.

With this general ignorance and misunderstanding of the economy, the speculator presence picked up significantly in mid-2012. At that time, the red-herring issue of low housing inventory was said by media pundits to be

Sky high optimism

The role of speculation in 2022-2023

appreciable assets

A collectible, such as real estate. The value of this asset may increase with time beyond the rate of consumer inflation.

pushing home prices higher. Perceiving a long-term price shift in the making, speculators began to flood in, month after month, increasing competition to buy homes freshly listed for sale.

They flocked from home to home, all submitting offers the instant each came up for sale. Their bet was to make money on market momentum pricing alone. End user buyers — the few out there — stood little chance in competing against novice but cash-heavy speculators intent on buying everything in sight. Property disclosure became meaningless in the process of furious acquisitions.

Return to normalcy

Speculators are notably diminished in 2021. They are discouraged by several influential market factors, in particular by the present state of home prices.

California home prices have crested going into 2022 and will begin to decline following the expiration of the foreclosure moratorium. This expiration occurred in Q3 2021, with an inventory swell expected heading into 2022. Investors, even impulsive ones, have a hard time justifying purchasing when inventory is rising and prices are falling.

Speculators will return once it is clear that prices have hit their bottom. Realty Publications, Inc. forecasts prices will bottom in 2022-2023. [See Factor 12: Pricing]

What motivates speculators to gamble?

Homebuyers of all types generally purchase homes for four reasons. These are, in order of importance:

- **annual property income** (in the form of rent which every property when leased generates);
- **equity build-up** (as asset value increases with inflation and as principal on mortgages is reduced);
- **appreciation** (as the location is sought out by more people or personal incomes locally rise faster than inflation - demographics); and
- the **tax benefits** of reduced taxable income due to homeownership (effective primarily for the wealthier, older population).

Speculators have this order of importance reversed. Their most significant motivation is the **potential tax benefits** of a purchase. Speculators are essentially day traders who think they've found an easy, tax-friendly investment. They take advantage of the federal government's homeownership incentive — **long-term capital gains** tax — by owning a *capital asset* for at least 12 months before selling. Thus, three years is the typical plan to warehouse title before implementing the initial intent to dispose of it by resale.¹

But not so fast – do speculators really qualify for the capital gains tax limit?

¹ Realty Publications, Inc. *Tax Benefits of Ownership*, 4th ed., Chapter 11: The tax treatment of a syndicator's earning

No, not really. In order to qualify, the property sold cannot be purchased with the intent to sell in the normal course of the speculator's business. Said more clearly, the speculator cannot be a dealer of property, in which the homes collected and sold are considered inventory — property held primarily for resale.²

So how do speculators get away with it? The answer is that many will not get away with it. If the Internal Revenue Service (IRS) audits these speculators, they will be asked to pay up.

Will today's gamblers cash out at a profit? Or take a loss? For the most part as in the past, they will not experience the returns they want, before or after taxes.

Real estate speculators assist a struggling housing market during recessions by providing cash — liquidity — bolstering sales volume when few users are willing to buy. But the magnitude of speculation which occurred in the 2013 recovery period was damaging, as liquidity needed by REO lenders and builders during a recession — the inability of an owner to find a buyer — was no longer the problem.

For developing headwinds adversely affecting sellers going into the next few years, think of:

- the **shadow inventory** of future forced sales, held back from the market in 2020 and into 2021, all to be released with the expiration of the foreclosure moratoriums at the end of 2021;
- speculators' combative acquisitions once prices have bottomed in 2022-2023;
- the historical real estate mean price trendline as a magnet to which real estate prices eventually return [See Chapter 12.4];
- the conditioning of the minds of prospective end users brought on by the 2020 pandemic and economic crisis;
- the eventual acceleration of housing construction starts as local politicians open up zoning to house the growing population; and
- the inevitable increase in mortgage rates and enforcement of mortgage lending fundamentals.

For casual observers of the real estate market place, speculator acquisition activity creates the illusion of a quickly recovering housing market. But by their removing homes from the grasp of end users, speculators actually prolong the housing recovery and corrupt the conduct of real estate agents willing to participate in the process. Can anything be done to suppress speculator activity to level out price movement (without unnecessarily restricting sales volume)?

Can speculation really drive a recovery?

shadow inventory

The inventory of properties whose pending release onto the market (e.g., REOs, foreclosures, speculator holdings) will destabilize real estate sales volume and prices.

The illusion of recovery

² Little v. Commissioner of Internal Revenue (1997) 294 CA9th 661

Yes. Institutional lenders need to implement underwriting guidelines that restrict loan-to-value (LTV) ratios by lowering them for speculators more than for buyer-occupants (and yes, speculators have avoided this by paying cash). The FHA has guidelines against flipping in an effective effort to modify price increases, though these were suspended in 2010-2014.

Other suggested regulations over speculator activity during recovery periods (not recessions) include historical solutions, such as:

- a down payment requirement of 30% for reason that speculators, with less of a vested interest in a property, are more likely to default than an owner-occupant;
- a restriction against purchase-assist financing of a flip within 180 to 360 days of acquisition by a non-resident buyer;
- an interest rate surcharge for non-resident buyers seeking financing (much like the mortgage insurance tacked on to home mortgages for more than 80% LTV for reason of higher risk and default rates among speculators); or
- an income tax rate surcharge on profits for a class of absentee homeowners who do not retain ownership and sell more than one home in four or five years.

Organic recovery

So what will truly support an **organic real estate recovery**? It all comes back to jobs, and wages received. End users need an income before lenders will fund home or commercial property purchases.

Jobs lost during the 2020 recession have yet to be recovered. As of July 2021, the number employed is still 1.3 million below the pre-recession peak. At the current pace of recovery, California won't regain these lost jobs until around 2024, when the economic recovery will finally begin to take hold. [See Factor 1: Jobs]

For now, do not depend on speculators to fuel your real estate sales in 2022. Look first at the local jobs numbers as they are published, and they will vary considerably depending on where in the state you are located. A pickup in sales volume will follow. Speculators come and go based on market momentum, and rising interest rates will hold back the market from overheating in the years following 2023.

Speculator transactions make up roughly 20% of all home sales in a normal, healthy housing market. During the recovery from the 2008 recession, the number inflated to 35%, decreasing to roughly 25% in 2014. During this time, prices jumped an amazing 20-30% year-over-year by the end of 2013, the highest jump being in low-tier home sales, continuing the steep rise in 2014. The price increase then was due solely to outsized speculator participation in the market.

The speculator presence to normal levels of around 20% by 2016 as the economic recovery began to solidify.

Real estate speculators assist a struggling housing market during recessions by providing cash — liquidity — bolstering sales volume when few users are willing to buy. But the magnitude of speculation which occurred in the 2013 recovery period was damaging, as liquidity needed by REO lenders and builders during a recession — the inability of an owner to find a buyer — was no longer the problem.

Speculators are notably diminished in 2021. Speculators will return once it is clear that prices have hit their bottom, forecasted to occur in 2022-2023, following the conclusion of the 2020 recession.

appreciable asset	pg. 53
shadow inventory	pg. 55

Chapter 3.1 Summary

Chapter 3.1 Key Terms

Chapter 3.2

Agreements for the flip of a property

Learning Objectives

After reading this chapter, you will be able to:

- identify the risk of loss in “flipping” a property; and
- discern the two ways speculators structure the transfer of their ownership rights on a flip.

Key Terms

bona fide purchaser (BFP)

syndication

flipping

When you need to flip, do it right

Speculators continue to be a factor in the California real estate market. Accordingly, speculators and their real estate agents need to know how to properly structure transactions and avoid causing undue stress for sellers, buyers and the real estate market as a whole.

In other words: *when you need to do it, do it right.*

Consider an undercapitalized speculator who locates a residence they want to buy. They intend to fix it up, immediately locate a buyer and resell the property. However, the speculator is not financially able to individually buy, rehabilitate and carry the property until closing the resale.

The speculator enters into a written purchase agreement to buy the property. Their intent is to sell and transfer their right to own the property before escrow is to close, to:

- an all-cash buyer who will acquire the speculator’s rights to ownership and become a substitute buyer; or
- a group of cash-heavy venture capitalists, formed by the speculator as a limited liability company (LLC), to fund the purchase price and carrying costs of ongoing ownership with the intent to later resell the property, a process known as **syndication**.¹

On the resale of the property to a buyer, the speculator will either:

- assign their right to purchase the real estate by entering into supplemental escrow instructions; or
- transfer their ownership interest using a grant deed by entering into a separate purchase agreement and escrow instructions with their buyer.

syndication

When a group of investors form a limited liability company to fund the purchase price and carrying costs of owning real estate.

¹ Realty Publications, Inc. *Forming Real Estate Syndicates*, 4th ed

When the speculator enters into supplemental escrow instructions to transfer their purchase rights to the property, the substitute buyer becomes an assignee. Escrow will close in the name of the assignee. This assignment is similar to the transfer of rights to an LLC to syndicate the acquisition of a property.

When the speculator chooses the alternative method of closing, the separate purchase agreement and escrow will close concurrent with, or after, the speculator's purchase escrow with the owner. This process is called **double escrowing**. Here too, the speculator avoids putting up more money than their good-faith deposit.

All purchase rights a speculator holds as a buyer may be assigned unless restricted by the purchase agreement or escrow instructions. Also, an assignment is barred when any personal performance promised by the original buyer under the purchase agreement will differ in the amount of risk when performed by the substitute buyer (assignee).

These riskier conditions occur with installment sales involving *carryback financing arrangements*. These require the substitute buyer to meet the same standards of creditworthiness and care of property as the initial buyer.²

Some investors will assign their purchase rights to a title warehousing agent. This allows the investor to complete a **reverse Internal Revenue Code §1031 transaction**. The common name used by the Internal Revenue Service (IRS) for this is a "parking transaction."

In a parking transaction, the seller is required to cooperate with the investor's assignment. The warehousing agent is not a substitute buyer, but a straw man who will merely hold title and later deed the property on to the investor.³

Further, when the purchase agreement allows for an assignment by the speculator, the seller may not require the speculator to close escrow and take title in their name instead of in the name of an assignee.

Under the vesting provisions in the purchase agreement, the conveyance of title by the owner is insured under a title insurance policy issued in the name of the buyer or assignee. The purpose of the vesting provision is to notify the owner that the speculator may assign their purchase rights to a substitute buyer who will close escrow under the purchase agreement.

Bound by the provisions of the purchase agreement, the owner needs to cooperate in good faith. They need to sign closing instructions and transfer documents. The owner's cooperation allows title to be conveyed and escrow closed in the name of the substitute buyer. [See **RPI** Form 150 §12.4]

After entering into a purchase agreement with a provision that imposes a duty on the owner to cooperate in an assignment, the speculator then:

- locates a substitute buyer;

² Calif. Civil Code §1457; **Masterson v. Sine** (1968) 68 C2d 222

³ **Nicholson v. Barab** (1991) 233 CA3d 1671

Assignment provision and vesting

- negotiates the price for their purchase rights; and
- enters into an agreement to sell and assign the purchase rights.

The resale by assignment

Documenting the speculator's assignment of purchase rights is best handled through supplemental escrow instructions. [See **RPI** Form 401-2]

A speculator assigns all of their purchase rights to the substitute buyer. In exchange, the speculator is promised a sum of money. This money is due on entering into the assignment or at the time escrow closes. [See **RPI** Form 401-2 §2]

The substitute buyer accepts the assignment. They agree to fully perform all of the obligations attending the speculator's purchase rights. By the assignment, the substitute buyer takes legal responsibility for the speculator's contract obligations delegated to the substitute buyer. This activity is called an **assumption**. [See **RPI** Form 401-2 §4]

Consider the speculator who assigns their purchase rights. Here, the substitute buyer "steps into the shoes" of the speculator as the buyer in escrow. The substitute buyer may now enforce the purchase agreement in their name. They may require the seller to close escrow by conveying the property to the substitute buyer.⁴

On accepting the assignment in escrow, the substitute buyer also assumes all of the speculator's obligations under the purchase agreement and escrow instructions. Once all contingencies are eliminated, disclosures are approved, and other rights to cancel are waived, the substitute buyer needs to perform. They then fund the purchase price and close escrow on the transaction. If not, they are liable for the owner's losses for wrongfully failing to close escrow.⁵

Liable to the speculator

Occasionally, the substitute buyer fails to close escrow without legal excuse or justification, called a breach of the purchase agreement. When a breach occurs, they are also liable to the speculator under the assumption provisions in the assignment. They are required to cover losses the speculator incurs due to the breach.

The speculator incurs money losses when the owner pursues the speculator for their losses or for specific performance on the breach. However, these claims are barred when the owner and speculator enter into a *release of liability* as part of the assignment documentation.

A release and substitution agreement requires the owner selling the property to look solely to the substitute buyer for performance of the purchase agreement and escrow instructions. Such an arrangement is called a **novation**.⁶ [See **RPI** Form 401-2 §7 and 8]

⁴ **San Francisco Hotel Co. v. Baior** (1961) 189 CA2d 206

⁵ **Fanning v. Yoland Productions, Inc.** (1957) 150 CA2d 444; CC §1589

⁶ **Bank of America National Trust and Savings Association v. McLaughlin** (1957) 152 CA2d Supp. 911; **Gates v. Quong** (1906) 3 CA 443

To comply with escrow instructions after the speculator assigns their purchase rights, escrow prepares all closing documents in the name of the substitute buyer. Closing documents include:

- deeds;
- carryback notes and trust deeds;
- closing instructions and statements;
- approvals and assumptions of any existing mortgages;
- title insurance; and
- clearance of any other items necessary for escrow to close.

A speculator **flipping** a property may not want to disclose to a substitute buyer the original seller's sales price. By informing the substitute buyer of the price the speculator paid for the property, the speculator also discloses their earnings on the flip. When the speculator does so, the owner will discover the resale price and may refuse (wrongfully) to cooperate and allow escrow to close in the name of the substitute buyer. The owner may feel they are also entitled to the speculator's quick profit.

Instead of assigning the purchase rights to a substitute buyer, the speculator simply resells the real estate, whether or not they have acquired title in their name.

Some counties additionally tax the resale on recording the second grant deed. The assignment of the rights to purchase avoids imposition of this tax. Also, there is the issue of the **Franchise Tax Board (FTB)** withholding 3% of the price on the resale, which causes speculators to incorporate and report as an "S" corporation to avoid FTB withholding on the resale.

On the speculator's resale of the property, the speculator and the prospective buyer will enter into an entirely new purchase agreement and set of escrow instructions. These are separate from the speculator's contracts with the owner.

In the context of a resale, the speculator undertakes the duties a seller owes a buyer to make all the disclosures required of a seller of real estate. The speculator may use the disclosures received from the seller, noting any additional or contrary information known to the speculator.⁷

The speculator on the flip opens a separate escrow for the resale. The sales escrow will be funded by the resale buyer and any purchase-assist mortgage lender. The speculator on the resale escrow typically uses the same escrow company handling the speculator's purchase escrow for convenience and reduced escrow charges. Also important when the escrows are to close concurrently is the transfer of funds from one escrow to the other.

The speculator's purchase escrow with the owner and the separate resale escrow opened with the substitute buyer may close concurrently, or separated in time.

A separate resale by grant deed

flipping

Buying and quickly reselling a property to obtain a large profit, the basis of speculation.

⁷ Shapiro v. Sutherland (1998) CA4th 1534

The closing of the resale escrow is conditional, contingent on the close of the speculator's purchase escrow with the owner. The speculator may choose to use their net sales proceeds from their resale escrow as the source of their purchase funds. If so, the speculator needs to close their resale escrow concurrently with their purchase escrow with the seller.

The double escrow

Through this double-escrow process, escrow records two grant deeds. One of these grant deeds will be from the seller to the speculator. The other grant deed will be from the speculator to the resale buyer in this variety of a flip.

Only one title insurance policy is issued when the closings are concurrent. Also, only one set of mortgage assumptions or mortgage origination documents are involved — all in the name of the substitute buyer. When the speculator's purchase escrow closes first, a binder form title policy is purchased at a 10% premium. Under the binder, a policy of title insurance is issued in the name of the substitute buyer when the resale escrow closes.

Editor's note — Property to be sold and funded by a Federal Housing Administration (FHA) issued mortgage may not be flipped within 90 days of a prior sale. The U.S. Department of Housing and Urban Development (HUD) instituted a temporary moratorium on that anti-flipping rule during 2010-2014. The moratorium was an effort to combat the illiquidity of real estate owned (REO) properties held by lenders during the foreclosure crisis.

Speculators are required to wait at least 90 days from their purchase before they may sell to homebuyers who are purchasing with FHA-insured mortgages.

Disclosures on a resale and agency considerations

The speculator offering to sell a one-to-four unit residential property fully discloses several facts. These mandatory disclosures include:

- physical, operating and title conditions; and
- natural and environmental hazards affecting the property.

The substitute buyer by assignment of the speculator's purchase rights receives copies of the:

- purchase agreement;
- escrow instructions; and
- all disclosures the speculator received from the owner.

On agreeing to the assignment, the substitute buyer acknowledges receipt of documents delivered by the speculator. [See **RPI** Form 401-2 §5]

Occasionally, the speculator is a real estate licensee acting on behalf of the property seller. Usually this agent is acting under a listing or property management agreement. This situation is conflicted by the fiduciary duties owed the owner/seller by the speculator-licensee.

Consider a broker employed to locate a buyer for a listed property. The broker prepares a purchase agreement naming themselves as the buyer and submits it to the seller.

Disclose all earnings

The purchase agreement calls for the seller to pay the broker a fee for acting as the seller's agent.

Prior to the close of escrow, the broker locates a substitute buyer. This substitute buyer agrees to acquire the broker's purchase rights by an assignment. The buyer will then become the substitute buyer in escrow. The substitute buyer pays the broker a transfer fee for the assignment.

The broker tells their seller the property's value does not exceed the purchase price set in their agreement. The seller agrees to the assignment of the broker's purchase rights to the substitute buyer.

At closing, the broker tells the seller they will receive an assignment fee for the transfer of their right to buy. However, the broker does not disclose the dollar amount of the fee.

After escrow closes, the seller discovers that the broker received 10% of the purchase price as consideration for the assignment.

Continuing on previous examples, the seller makes a demand on the broker for the assignment fee and the return of the brokerage fee they paid. The seller claims the broker breached their fiduciary duty owed the seller by deception since they failed to disclose the amount of the benefits received while acting as the listing agent. Further, the seller claims the broker deprived the seller of their ability to sell the property for its highest possible value.

Agent failure to disclose the benefits of a flip

The broker claims they had no duty to disclose the price paid by the substitute buyer for the assignment since the broker's status under the purchase agreement was that of a principal. Thus, the broker claims they had an interest in the property which they could sell.

Did the broker breach their **fiduciary duty** under the listing agreement by failing to disclose to the seller the dollar amount of the broker's benefits on their flip of the property under their purchase agreement with the seller?

Yes! The listing agreement created a fiduciary duty owed by the broker to the seller. Since the broker did not first terminate the listing agreement, the broker was required to disclose all earnings.

The broker did not extinguish their agency duties before entering into the purchase agreement to buy the listed property as a principal.⁸

A broker needs to disclose the full extent of all benefits received due to their or their agent's involvement in transactions related to the property listed (or bought on behalf of a buyer). [See **RPI Form 119**]

⁸ **Roberts v. Lomanto** (2003) 112 CA4th 1553

Special rules for EP speculators

When purchasing a residential property from a seller-in-foreclosure, **equity purchase (EP) laws** further regulate the speculator’s activities. EP laws are designed to protect vulnerable sellers. [See **RPI Form 156**]

When a speculator violates the EP statutes the seller-in-foreclosure has a statutory two-year right of rescission. On an assignment of the speculator’s purchase rights, the seller’s rescission rights extend to the substitute buyer.

However, this extension of rights is inapplicable to flips by a speculator on the sale of real estate to a third-party buyer. When the speculator flips it in a separate arms-length resale, the buyer is a **bona fide purchaser (BFP)**. As such, the buyer by grant deed is exempt from the seller’s two-year right of rescission under EP law. This exemption applies even if the resale buyer knows the property was in foreclosure when the speculator acquired it.

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.

Chapter 3.2 Summary

Speculators continue to be a factor in the California real estate market. Accordingly, speculators and their real estate agents need to know how to properly structure transactions and avoid causing undue stress for sellers, buyers and the real estate market as a whole.

On the resale of the property to a buyer, the speculator will either:

- assign their right to purchase the real estate by entering into supplemental escrow instructions; or
- transfer their ownership interest using a grant deed by entering into a separate purchase agreement and escrow instructions with their buyer.

When purchasing a residential property from a seller-in-foreclosure, equity purchase (EP) laws further regulate the speculator’s activities. EP laws are designed to protect vulnerable sellers.

Chapter 3.2 Key Terms

bona fide purchaser (BFP) pg. 64
flipping pg. 61
syndication pg. 58

Factor 4: Homeownership



Homeownership as a savings plan

Chapter 4.1

After reading this chapter, you will be able to:

- understand the process in which homeowners increase or decrease their wealth by funding the ownership of their shelter.

home equity line of credit

implicit rent

loan-to-value ratio

opportunity cost

Learning Objectives

Key Terms

Homeownership represents a deliberate allocation of family wealth to shelter. This allocation of wealth is a present commitment to:

- accumulate cash savings for a down payment to acquire ownership; and
- budget future income for mortgage payments, ownership costs and maintenance required to retain that ownership.

Ownership of the family's home, however, may not logically be treated as an investment. At best, it is a store of wealth with periodically changing value. Nor may it ever be treated as a consumable product. It is, however, the

Implicit rental income offsets owner's risk of loss

object of an emotional and social need — and personal shelter. Arguably, the desire for possession in the form of ownership rather than renting is driven somewhat by personal insecurities over family income, eviction and loss to foreclosure.

opportunity cost
The cost of an action that is forgone in choosing to take an alternative action.

An **opportunity cost** issue arises when you allocate cash savings and future income to build home equity to store wealth. This cost is the lost interest earnings — the opportunity — you would have received had the cash been placed in savings or invested in bonds (or equities).

implicit rent
The value of an owner's use of their property to house themselves or their business.

Also, consider monthly mortgage interest expenditures, excluding the amortized principal reduction which builds equity in the home. This cost of ownership is offset by the amount of **implicit rent** the homeowner receives as a benefit of their occupancy due to ownership. While the owner does not actually pay rent to themselves, they need to realistically charge themselves for their use of the property, then offset the rental value by the carrying cost they incur due to the ownership — mortgage payments, property taxes, insurance, maintenance and like items they would not pay if they actually were a tenant in the property.

The amount of equity in a home is a financial cushion that absorbs the effects of a local economic downturn or a family financial emergency. As with any family nest, the homeowner's instinct for self-preservation and financial security rationally compels them to establish the ultimate equity: a home free and clear of debt.

Clear of debt, the family attains an equity (100%) that provides the maximum ability to retain the home against all odds (read: risk of loss). Thus, the family's solvency is ensured and the amount of homestead equity is placed beyond the reach of the sheriff.

home equity line of credit (HELOC)
A mortgage loan enabling a homeowner to borrow against their home's wealth, as an ATM.

Equity loans, also known as second mortgages and **home equity lines of credit (HELOCs)**, were forbidden in California until 1986. The purpose was to shield families from insidious lending practices such as occurred in the 1930s Great Depression and the years following 1986 to the 2008 recession.

Until the 1980s, a homeowner in need of cash who wanted to borrow against the wealth stored in the equity of their home entered into an agreement with the bank not to sell or further encumber the family home. Lenders were barred from taking a second trust deed lien on a personal residence. However, in 1986 mortgage bankers engineered congressional action and unlocked the equity in the millions of California homes to provide collateral for ever more mortgages.

Deregulation rears its head

The home equity loan was created by *deregulation*. The purpose of deregulation was not to preserve or increase homeownership, or to better prepare the population to provide for themselves in old age. Rather, deregulation was motivated by the government's expressed desire to have

consumers spend beyond the constraints of their personal incomes. The economy following 1985 was in need of a lift in consumer spending to keep people employed. Likewise, lenders needed additional sources of borrowers.

1986 introduced the tax advantage of writing off the interest on *HELOCs* which funded purchases such as cars, trucks, vans, stock market speculation, homes-to-let and, as a long-term benefit, education.

Everything on this trajectory seemed to be going well until the *purchasing power* of personal income began to decline nationally after 2000. Since homeowners were no longer able to keep up their standard of living due to the rate of consumer inflation exceeding increases in pay, a home value with the ability to support a second mortgage triggered the “ATM effect” to satisfy the additional cash needs of the employed.

Eventually, the financial deregulation which permitted second trust deed liens led to no-down payment acquisitions funded by piggyback second mortgages and seller kickbacks to buyers on closing. Big Banks observed that the **financial accelerator** event of repeatedly lending increasing amounts secured by the same collateral was driving property prices up. With rising prices of homes dramatically increasing a home’s equity beyond that of a proper down payment, the banks felt they were covered in the event of a default.

Then came HELOCs secured by the principal residence. These open-ended financial arrangements equipped the homeowner with funds to purchase consumer goods and speculate at a whim. As a financially hazardous side effect, HELOCs further encumbered the family home. In turn, this reduced family balance sheets (solvency) and the ability to retain ownership of the home during the inevitable recession that was soon to come.

In reality, the risk of losing the family home is directly proportional to the **loan-to-value ratio (LTV)** for the mortgage encumbering the residence. For a reality check, consider a homebuyer who purchased a property in California in early 2006, the peak of real estate values. Now consider the same property in 2016. After a period of ten years, the property was only valued at 80% of what it was in 2006.

In 2021, all of those who purchased in 2006 have finally regained positive equity in their residence. Still, the intervening years saw these individuals stuck in their homes far longer than they may have expected, unable to sell without choosing the drastic measures of short sale or foreclosure. Further, looking ahead to the end of the **foreclosure moratorium**, 90+ day delinquencies are building, suggesting a foreclosure wave is quickly approaching to drag down home values in 2022-2023.

Decline of purchasing power

loan-to-value ratio (LTV)

A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property’s fair market value.

Chapter 4.1 Summary

Homeownership represents a deliberate allocation of family wealth to shelter. This allocation of wealth is a present commitment to:

- accumulate cash savings for a down payment to acquire ownership; and
- budget future income for mortgage payments, ownership costs and maintenance required to retain that ownership.

Equity loans, also known as second mortgages and home equity lines of credit (HELOCs), were forbidden in California until 1986. The purpose was to shield families from insidious lending practices such as occurred in the 1930s Great Depression and the years following 1986 to the 2008 recession.

Chapter 4.1 Key Terms

home equity line of credit (HELOC)	pg. 66
implicit rent	pg. 66
loan-to-value ratio	pg. 67
opportunity cost	pg. 66

Negative equity and foreclosure

Chapter 4.2

After reading this chapter, you will be able to:

- discuss the factors which cause strategic default to make financial sense for a negative equity homeowner.

forbearance agreement

negative equity

Learning Objectives

Key Term

Conventional wisdom holds that foreclosures are triggered when homeowners owe more on their mortgages than the market value of their homes, a financial condition called **negative equity**.

Experienced by a debilitating third of California's homeowner population in the years immediately following the Millennium Boom, negative equity is universally feared by homeowners, lenders and policymakers alike. Consistent with this wisdom, negative equity is often fingered as the primary cause for the rise in foreclosures that invariably accompanies a bust in real estate pricing.

In response to the increase in negative equity and the corresponding foreclosure frenzy in 2008-2011, the government unleashed a series of policies attempting to induce lenders to offer a *mortgage modification* in lieu of foreclosure. If negative equity is the problem, mortgage modifications, preferably in the form of reduced mortgage debt (also known as a cramdown), are the preferred solution. Yet government efforts to generate mortgage modifications were largely unsuccessful.

The reason being, lenders generally disregard *government incentives* to modify mortgages. But they are less able to ignore the lawsuits of state attorneys general, which do induce action. Without modifications, marginally solvent homeowners with negative equity default and go into foreclosure, a drag on the state's economy.

When lenders do choose to modify a mortgage, they tend to leave the mortgage balance intact, limiting the modification to a mere reduction of the dollar amount of scheduled payments in exchange for an elongated term.

That lender perspective is best encapsulated in a 2008 study from the Federal Reserve Bank of Boston (FRBB). Contrary to popular belief, the FRBB found negative equity on its own is rarely sufficient to induce foreclosure, as reported in their study, entitled *Negative Equity and Foreclosure: Theory and Evidence*. By examining historic foreclosure rates in Massachusetts over a 20-

A crisis squandered by an inactive government

negative equity

The condition of a property owner owing more on a mortgage than the current fair market value of the encumbered property.

year period, the report's authors discovered that over 90% of homeowners with negative equity continued to pay their mortgages. A 2016 paper by the FRBB identified the main culprit for strategic default as a job loss or other *financial shock*, with negative equity status rarely playing a role. These points are not lost on mortgage lenders.

In fact, the report demonstrates that default almost always remains an unlikely used option for homeowners. The homeowner is faced with many economic disincentives that accompany the foreclosure process. These drive them to hold on to their homes, in spite of the personal and financial costs. Prisoners in their own home, policed by the lenders.

Negative equity plus a shock spells default

Even when the outstanding mortgage balance exceeds the home's market value, it is almost always a more fiscally sound decision for homeowners to continue making payments on their mortgages if they are able, according to the FRBB report. This is due to:

- the costs of relocating;
- the loss of credit; and
- the emotional distress associated with failing to keep their home.

Combined, these factors keep homeowners in their residences — imprisoned — unless some external factor tips the scale of their judgment. Homeowners generally do not default and go into foreclosure on their homes unless negative equity is combined with a *household income shock* (e.g., loss of job, divorce, loss of health, death, mortgage resetting, etc.) that places the mortgage payment beyond their reach.

The FRBB article concludes that if the preponderance of underwater homeowners is not in fact at risk of default due to their inability to pay, then mortgage modifications that reduce the mortgage balance or interest rate are an unnecessary loss for lenders.

Why would lenders effectively offer discounts to owners who would never have defaulted in the first place?

This logic also applies to the approval of a **short sale**. *Short sale* approval involves a discount given to owners who will not default and force a foreclosure sale, but are actively seeking a way out from under their mortgage debt. They force the issue by selling at current prices, contingent on the lender discounting for a final payoff.

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.

Forbearance agreements temporarily reduce monthly mortgage payments but do not alter the original terms of the mortgage. These are more frequently considered by lenders. Unlike other assistance measures, forbearance agreements are economically beneficial only to homeowners at serious risk of foreclosure. Lenders who use forbearance agreements can thus direct their resources where they will be most effective — foreclosing on the insolvent homeowners.

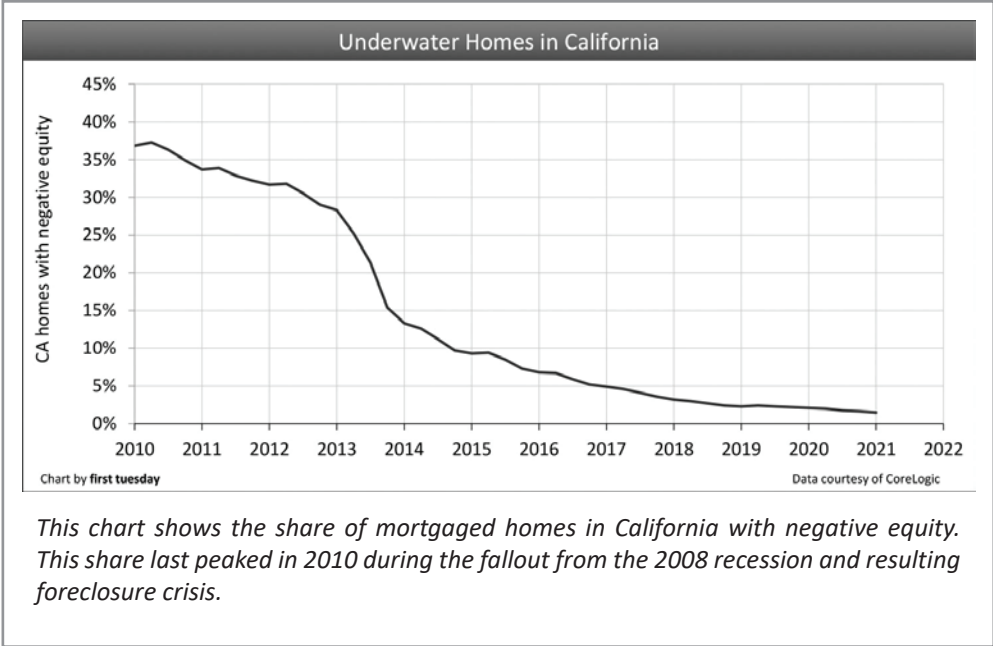


Figure 1
Underwater Homes in California



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The share of mortgaged homes with negative equity in California declined to 1.5% in the third quarter (Q3) of 2020. This is down from 2.0% a year earlier and 37% at the height of the foreclosure crisis, in 2010. The majority of negative equity homes are located in the state’s inland regions.

Negative equity in the years’ ahead

A sharp decline in negative equity occurred in 2012-2013 as rapidly rising prices lifted many underwater homeowners into positive equity positions. However, the disappearance of speculators (and the rapid price lift they wrought from the single family market in 2014) led to a more gradual rise in home values that continued through 2020. [See Figure 1]

As home values hit a peak going into 2021, the number of underwater homeowners is expected to level out and begin to rise by 2022, picking up speed in 2022-2023 as more foreclosures hit the market following the end of the foreclosure moratorium, scheduled to occur in mid-2021. As of Q3 2020, 4.8% of homes nationwide had a series (90+ day) delinquency, the highest level since 2010, and growing.

Chapter 4.2 Summary

In response to the increase in negative equity and the corresponding foreclosure frenzy in 2008-2011, the government unleashed a series of policies attempting to induce lenders to offer a mortgage modification in lieu of foreclosure. If negative equity is the problem, mortgage modifications, preferably in the form of reduced mortgage debt (also known as a cramdown), are the preferred solution. Yet government efforts to generate mortgage modifications were largely unsuccessful.

Absent a household economic shock, it is financially more responsible for many negative equity homeowners to remain in their home rather than default, though few choose to default unless forced to by a financial shock.

Chapter 4.2 Key Terms

forbearance agreement pg. 70
negative equity pg. 69

A balance sheet reality check

Chapter 4.3

After reading this chapter, you will be able to:

- prepare a balance sheet for your homeowner; and
- analyze homeowner assets and liabilities.

balance sheet

illiquid asset

liability

statement of financial position

Learning Objectives

Key Terms

The 2008 recession wiped out trillions of dollars of home asset wealth across the nation. However, few states experienced the severe rise and fall of prices in the real estate market as acutely as California. As we continue through the hangover from the 2020 recession, home values are poised to fall once again.

Still, just 1.5% of California's mortgaged homeowners are financially locked into houses that are black-hole assets going into 2021. But looking back for a look forward will show us a potential path for home values, and the homeowners who purchased at the peak of prices. Once home values begin to fall, each month of continued ownership for those who purchased within the past year or two sucks up exponential sums of money compared to what the home will rent for — its economic value to the owner-occupant, called implicit rent. This occurred in the decade following the 2006 peak in home values and is likely to next occur in the 2022-2024 period.

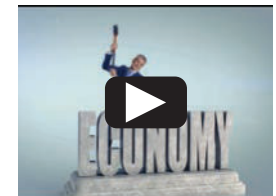
Two breeds of negative equity homeowners exist:

- those who are *fully aware* of their financial plight and have tried to get relief but cannot; and
- those who *aren't aware* or are in deliberate disbelief of their precarious financial footing.

After the 2008 recession hit and home prices took a steep dive, a significant portion of California homeowners found themselves stuck, still paying on dead-end mortgages years after they purchased. These mortgages, while amortized, contributed nothing to the equity in the owner's home. Some homeowners defaulted, but many more stayed, hitched to their black-hole assets.

In 2021, the share of underwater homes has finally returned to normal levels. However, as prices reverse course following the end of government support, the presence of negative equity will again become more common.

Underwater property: the family's black-hole asset



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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]

statement of financial position

A balance sheet prepared by a homeowner which lists the dollar amounts of the homeowner's assets and liabilities. [See **RPI** Form 209-3]

Family financial planning: using a balance sheet

liability

A financial debt or obligation owed to others.

illiquid asset

An asset that cannot be converted into cash quickly without a loss.

The answer is a **balance sheet**. This is a worksheet used to list in dollar amounts all the homeowner's assets and liabilities. It is an ideal tool to decipher a homeowner's, and by extension the family's, financial status at a given time. The use of the balance sheet, also called a **statement of financial position**, is a simple exercise in financial planning. The analysis needs to be conducted by every household (and investor and businessperson) at the end of each year.

Preparation of a balance sheet is especially instructive to families who purchased or refinanced after 2002 since they may be underwater. Further, the primary bulk of a homeowner's assets and debt is typically singularly comprised of their home. [See Figure 2, **RPI** Form 209-3]

In contrast, a *profit and loss (P&L) worksheet* is a separate but tandem financial statement. It is used to review the homeowner's monthly income and expenditures. [See **RPI** Form 209-3]

A P&L deals not with the value of the home or the mortgage amount, but lists the homeowner's cashflow:

- personal income;
- monthly expenses; and
- ongoing obligations, including mortgage payments.

With a firm mental grasp on the family finances through completion of a balance sheet, forward-looking and prudent financial decisions can be made.

The balance sheet approach to setting a homeowner's net worth is meaningful for a knowledgeable real estate broker or agent. This financial statement assists individuals in their estate building through the ownership of real estate as either a store of wealth, as with their home or land, or an investment in income property.

Investors and families accounting for the dollar amount of the annual increase in the value of their assets usually do so after the end of each year — often at the same time they prepare their annual income tax return. The analysis reveals whether the family is on track to meet long-term financial goals, or whether the family is insolvent and in need of a change in behavior or assets. The balance sheet also helps the family rationally determine which assets to best spend their earnings on and which assets they need to discard.

A balance sheet distinguishes the relation between two basic financial categories: **assets** and **liabilities**. Assets are tangible and intangible items of value held by the homeowner. Among them are liquid assets which take the form of cash or something easily converted to cash, and include money held in a savings account and tradable stocks and bonds. [See Figure 2, **RPI** Form 209-3 §1 and 2]

Generally, the largest dollar-valued asset a homeowner will ever own is their home. It is historically considered an **illiquid asset** as its equity cannot quickly be converted to cash. With a positive equity stake in the home, the

BALANCE SHEET FINANCIAL STATEMENT
Assets, Liabilities, and Net Worth

Prepared by: Agent _____ Phone _____
Broker _____ Email _____

NOTE: This form is used by a loan broker when processing a mortgage application, to be prepared by the borrower for the loan broker to determine the borrower's net worth. This statement and attached schedule is to be completed by both co-borrowers if their assets and liabilities are sufficiently jointed to make one combined statement viable. If not, each co-borrower is to prepare their separate statements.

DATE: _____ 20____ Prepared by _____
FOR: _____

SECTION I - ASSETS:

1. Checking and saving account information:

1.1 Name of depository _____ Account No. _____ \$ _____
Address _____

1.2 Name of depository _____ Account No. _____ \$ _____
Address _____

1.3 Name of depository _____ Account No. _____ \$ _____
Address _____

1.4 Name of depository _____ Account No. _____ \$ _____
Address _____

1.5 Name of depository _____ Account No. _____ \$ _____
Address _____

2. Tradable stocks and bonds:

2.1 Company name _____ \$ _____
Description/Quantity held _____

2.2 Company name _____ \$ _____
Description/Quantity held _____

2.3 Company name _____ \$ _____
Description/Quantity held _____

2.4 Company name _____ \$ _____
Description/Quantity held _____

3. **SUBTOTAL** of liquid assets (sum of lines 1.1 through 2.4) _____ \$ _____

4. Real estate owned (enter market value from line 17.7(a)) _____ \$ _____

5. Vested interest in retirement fund _____ \$ _____

6. Net worth of businesses owned:

6.1 Name _____ \$ _____
Percentage owned _____%, entity type _____
(attach current and prior year profit and loss statement)

6.2 Name _____ \$ _____
Percentage owned _____%, entity type _____
(attach current and prior year profit and loss statement)

6.3 Name _____ \$ _____
Percentage owned _____%, entity type _____

PAGE 1 OF 3 - FORM 209-3

PAGE 2 OF 3 - FORM 209-3

7. Notes owned:

7.1 Unpaid principal of trust deed notes _____ \$ _____

7.2 Unpaid principal of unsecured notes _____ \$ _____

8. Vehicles owned (market value):

8.1 Make _____ year _____ \$ _____

8.2 Make _____ year _____ \$ _____

8.3 Make _____ year _____ \$ _____

8.4 Make _____ year _____ \$ _____

9. Other assets (collectibles, equipment, etc.):

9.1 Description _____ \$ _____

9.2 Description _____ \$ _____

9.3 Description _____ \$ _____

10. **TOTAL** assets (sum of lines 3 through 9.3) _____ \$ _____

SECTION II - LIABILITIES:
Include auto loans, charge accounts, real estate loans, alimony/child support, loans collateralized by stock/bonds/notes, etc.

11. Creditor or loan information:

11.1 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.2 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.3 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.4 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.5 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.6 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.7 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.8 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

11.9 Name of Creditor _____ Account No. _____ \$ _____
Address _____
Type of debt _____ Months left _____

12. Spousal support owed to _____ \$ _____

12.1 Child support owed to _____ \$ _____

13. Job-related expenses:

13.1 Union dues _____ \$ _____

13.2 Child care _____ \$ _____

13.3 Other _____ \$ _____

PAGE 2 OF 3 - FORM 209-3

PAGE 3 OF 3 - FORM 209-3

13.4 Other _____ \$ _____

14. **TOTAL** monthly payments _____ \$ _____

15. **TOTAL** liabilities _____ \$ _____

16. **NET WORTH** (line 10 minus line 15) _____ \$ _____

SECTION III - REAL ESTATE OWNED:

17. Property description:

	a	b	c	d	e	f	g
	Market Value	Liens/Amount	Owner's Equity (minus line b)	Monthly Rental Income	Monthly Operating Expenses	Monthly Net Income	Specified account for net worth (line a and f)
17.1 Type _____							
17.2 Type _____							
17.3 Type _____							
17.4 Type _____							
17.5 Type _____							
17.6 Type _____							
17.7 TOTALS _____							

The information provided above is true and correct.
Date: _____ 20____ Name: _____
Date: _____ 20____ Name: _____

Signature: _____ Signature: _____

FORM 209-3 03-11 ©2010 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517

Figure 2
Form 209-3
Balance Sheet
Financial
Statement
Assets,
Liabilities and
Net Worth

For a full-size, fillable copy of this or any other form in this book that may be used in your professional practice, go to realtypublications.com/forms

owner treats it as a valued asset and thus maintains and improves it. Over time, the property's equity buildup (mortgage principal reduction, inflation and appreciation in value) can be cashed-out by either further financing or sale.

Other items make up a homeowner's assets, such as funds held in retirement accounts, ownership interests in businesses and trust deed notes owned. Vehicles and equipment owned are also assets, as well as furniture, electronic equipment and any other item of recognized value, such as collectibles. [See **RPI** Form 209-3 §5 through 9]

Liabilities are the flip-side of the financial coin. Together, liabilities and net (or negative) worth are equal to the value of the assets. The formula is:

assets minus liabilities equals net worth.

Liabilities included in a balance sheet are financial obligations and debts owed to others, including:

- real estate mortgages;
- auto mortgages;
- charge accounts;
- credit card balances;
- one year's amount of alimony/child support/lease payments; and
- mortgages collateralized by stocks, bonds or notes. [See Figure 2, **RPI** Form 209-3§11 through 15]

Dear, our financial net- worth has shrunk...

A homeowner's net worth is revealed when their total liabilities are subtracted from the current FMV of their assets. Personal net worth is a primary determinant of financial wealth all individuals need to know about themselves. When net worth is positive, the homeowner is worth more than they owe to their creditors — the homeowner is solvent.

However, this balancing act is immediately upended when a high-value asset, such as the homeowner's residence, has a negative equity. If the negative equity is large enough, the value of the homeowner's other assets on a balance sheet is overwhelmed. Their net worth appears as a negative figure. Instead of a positive measure of wealth, the negative net worth is a measure of **insolvency**.

When insolvent, the homeowner is a candidate for bankruptcy protection. It is in this context that the agent reviews the pros and cons of the homeowner continuing to own and occupy the property.

Editor's note — This corrosive net worth phenomena driven by negative equity property is particularly rampant and damaging for those in the Baby Boomer generation who live in inland suburban areas. They have fewer years remaining in the workforce to recover and pricing in the periphery to the coastal areas has not yet fully recovered their 2006 valuations.

Boomers experienced close to 50% losses in the stock market on two separate occasions in recent years (likely because they were told by their commissioned 401K investment counselors to put their money into stocks, not bonds, a prudent shift as they grew older).

They were hit a second time with the devastating loss of over 50% of the value of their homes, which too many had refinanced to obtain additional funds and are now trying to sell so they can relocate.

Financial advice by the owner's agent

An agent reviewing homeownership with an owner needs to instruct the owner to keep long-term estate building in mind when considering the data provided in the balance sheet. The closer the relationship of the agent is to the client, the tighter the bond enduring between them. Financial planning

is about as close as you can get, so do not leave it to unlicensed financial consultants to take the opportunity away regarding whether to buy or to sell real estate.

After the owner prepares a balance sheet for review by their real estate agent, it will become clearer which assets need different management decisions. In this context, an upside-down house needs to be considered for disposal to free up monthly cash flow for more prudent family expenditures. The financial impact of a homeowner’s current mortgage situation directly affects their annual increase in net worth and their ability to achieve long-term financial goals from their future income.

A negative equity homeowner diverts large sums of cash monthly, now and into the distant future, which exceed the rental value of the property they receive for their occupancy and will never be returned in any form. Thus, reaching reasonable long-term family goals is impossible with a black-hole asset on the balance sheet.

All homeowners, especially those encumbered by negative equity, need to prepare a balance sheet to assess their net worth each year. This is a worksheet used to list in dollar amounts all the homeowner’s assets and liabilities. It is an ideal tool to decipher a homeowner’s, and by extension the family’s, financial status at a given time. The use of the balance sheet, also called a statement of financial position, is a simple exercise in financial planning. The analysis needs to be conducted by every household (and investor and businessperson) at the end of each year.

A homeowner’s net worth is revealed when their total liabilities are subtracted from the current fair market value (FMV) of their assets. Personal net worth is a primary determinant of financial wealth all individuals need to know about themselves. When net worth is positive, the homeowner is worth more than they owe to their creditors — the homeowner is solvent.

balance sheet pg. 74
illiquid asset pg. 74
liability..... pg. 74
statement of financial position pg. 74

Chapter 4.3 Summary

Chapter 4.3 Key Terms

Notes:

Factor 5: Home sales volume



Home sales volume and price peaks

After reading this chapter, you will be able to:

- interpret recent trends in California home sales volume; and
- understand the factors influencing future home sales volume.

bumpy plateau recovery

real estate owned property (REO)

Home sales vary from month-to-month for a variety of reasons, most significant being homebuyer demand. This demand is influenced by several factors constantly at work in California's homebuying market, including:

- seasonal differences;
- changes in home prices;
- mortgage interest rates;
- consumer confidence;
- the presence of investors and real estate speculators in the market;
- negative equity status;
- the quantity and quality of jobs held by homebuyers; and
- homebuyer saving rates.


Chapter 5.1

Learning Objectives

Key Terms

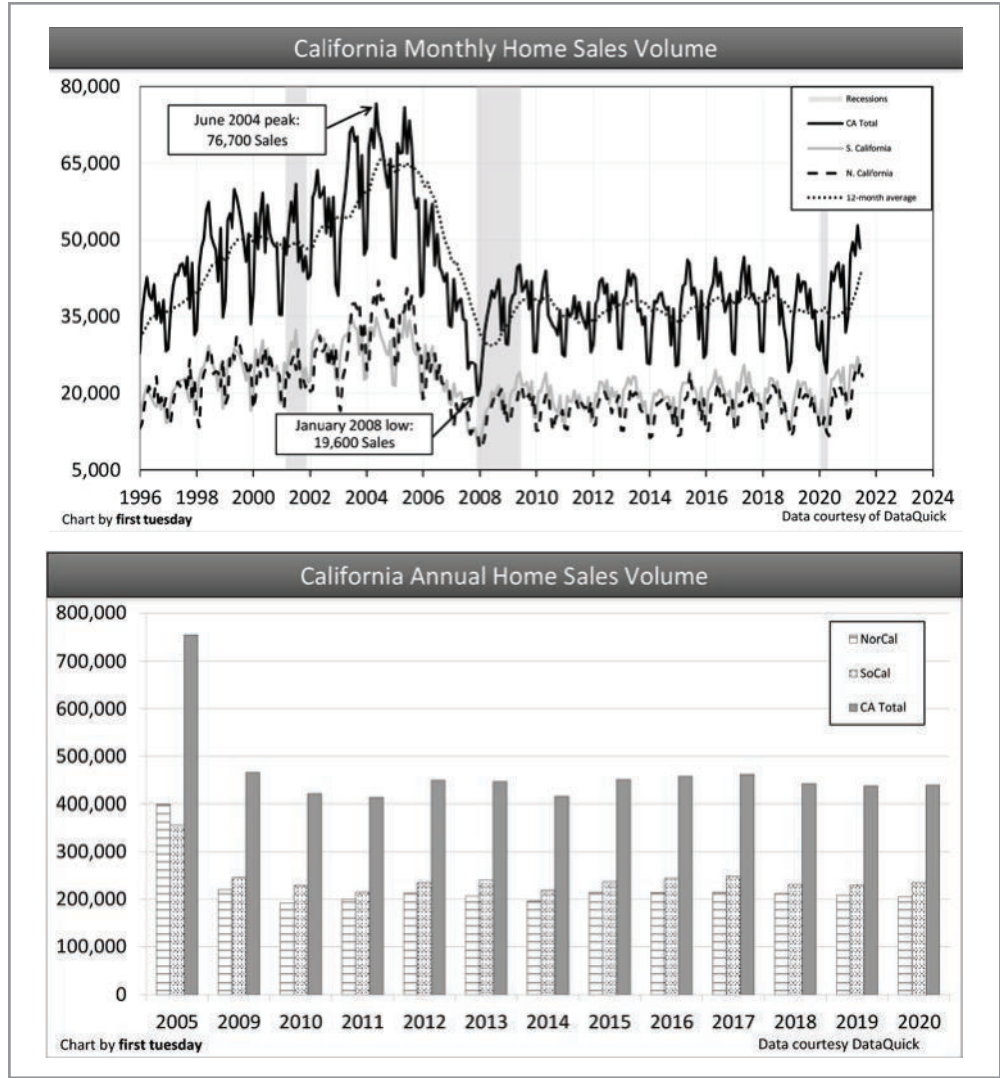
A long recovery for sales volume

Figure 1
California
Monthly Home
Sales Volume
and
California
Annual Home
Sales Volume


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



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.



Annual real estate sales numbers since the Great Recession of 2008 have been characterized by a continuing **bumpy plateau**. While homes sales volume varies from month to month, the overall annual trend has been flat to down. Within the annual sales cycle, the most homes are regularly sold each year in mid-year. Another small increase takes place in December, as homebuyers seek to wrap up their financial activities before the end of the year.

Therefore, real estate professionals are not to worry when they hear of falling sales volume in the latter half of the year. This is a normal seasonal progression. What to watch for is year-over sales comparing a month or other period (such as year-to-date) this year with the same month or period last year.

2020 ended with 439,200 home sales in California. This was 1,700 more home sales than took place in 2019, amounting to a meager increase of 0.4%. 2020's overall flat performance follows a 1% decrease in 2019 and a 4% decrease in 2018. For greater perspective, 2020's 439,200 homes sales volume was 42% below peak sales volume experienced in 2005.

As a rule, current market action, whether up or down, is reflected first in sales volume, followed by prices. Both fluctuate on a monthly basis, but longer trends in sales volume are a strong influence on home prices.

Realty Publications, Inc. forecasts home sales will flatten and decline in 2022, slowing the flow of agent fees. Rapidly rising prices and gradually rising interest rates, along with uncertainty brought on by the inventory boost from the expiration of the foreclosure moratorium in July 2021, will discouraged potential homebuyers and derail sales. Therefore, home sales volume won't recover until after home prices bottom following the expiration of the foreclosure moratorium, expected heading into 2023.

For a forward look, some review of sales volume in the recent past is needed to set the stage:

- Mid-2005 saw sales volume peak for all types of real estate in California;
- Early 2006 produced both the peak in sales prices and the initial precipitous decline in sales volume. Nearly 30% fewer sales were recorded in 2006 than in 2005;
- In 2007 sales volume dropped another 30%;
- 2009 sales were artificially higher than anticipated due to subsidy-induced purchases and speculator acquisitions, but remained 40% below the 2005 peak year;
- 2010 saw a decline from the year earlier in both sales volume and prices as subsidies ended and speculators left for lack of price momentum;
- 2011 increased slightly in sales volume due to a decrease in sales prices;
- 2012 and 2013 saw level sales volume and suicidal home price increases, supported almost entirely by massive speculation;
- 2014 experienced sales volume 7% below 2013 while home prices continued to increase; and
- 2016 and 2017 sales volume continued a flat trend in sales which began in 2015; and
- 2018 saw sales volume decrease rapidly in the fourth quarter, ending the year 4% below 2017.

In 2021, home sales volume will be roughly 35% higher than 2020.

Real estate owned property (REO) resales, short sales volume and speculators have contributed to sales volume oddities since 2006. Conventional positive equity sales were the exception until 2015.

2009 through 2013 introduced massive quantities of REO resales. REOs in 2014 continued to arrive but in a quickly declining trend, the REO volume offset by an increase in short sale and investor purchases at trustee's foreclosure sales. These conditions tapered off in 2016 and disappeared almost entirely in 2017.

Causes for the rise and fall

real estate owned property (REO)
Property acquired by a lender through foreclosure.

However, at some point shortly after mortgage rates rise in 2018, delinquencies will rise and foreclosures and REO resales (and bankruptcies) will see a brief — and small — bounce. Rising mortgage rates will then take speculation and momentum pricing out of the housing market for a decade or more in a return to the mortgage economics of the post-Depression 1950s and 1960s.

Speculators and buy-to-let investors artificially drove 2008 and 2009 sales volume above 2007 sales, with a sales volume peak in July 2009. This 2008-2009 fast-track rise and sudden peak represents the classic initial dead cat bounce in a real estate recession. Homebuyer subsidies followed, artificially pre-loading sales activity by cannibalizing future sales but doing nothing for the overall real estate recovery.

The bounce loses energy and hunts for the floor

Now fast-forward into 2021. Despite significant gains, sales volume remains historically low for our population mix, reflecting a continuing supply-and-demand imbalance.

Sales volume in 2014 fell 8% from the prior year. This was due to end user homebuyers discouraged and driven out of the homebuying market by steep home price increases, mortgage rate increases and general pessimism. However, mortgage rates fell in December 2014-January 2015, giving homebuyers a needed boost in buyer purchasing power and renewed confidence in their home buying prospects. This helped lift home sale numbers in 2015.

Likewise, in 2020 sales volume plunged in the first half of the year due to pandemic-induced economic panic. At the same time, the Federal Reserve (the Fed) dropped their benchmark interest rate to zero. Along with bond market investor behavior, this was sufficient to drop mortgage interest rates to historic lows in Q1 2021. While any rise in rates instantly restrains real estate sales activity producing a drop in sales volume, 2020-2021's record-low interest rates gave both home sales volume and prices a boost.

Expect the Fed-controlled short-term rate to begin to rise around 2023, which will further restrain sales volume. Before that occurs, the Fed will begin their **bond taper**, drawing down mortgage-backed bond (MBS) purchases, which will also cause mortgage lending activity to decline. Reduced sales volume historically occurs with an interest rate rise to make corrections in the recovering economy as took place in the mid-1980s and mid-1990s, and fatefully in 2004.

Sales volume's next big peak will occur in the years following 2024, with a peak in pricing following 12 months later.

The real estate market's drawn-out recovery from the 2008 recession was due to buyers (in the form of end users) not reaching sufficient numbers to set up a boom time event. Now, as we progress through the 2020 **recession hangover** and forthcoming recovery, a full recovery for sales volume won't occur until the start of next housing cycle, in the years following 2023. Only

then will end users return in sufficient numbers for sales volume to swell without falling back in 12 to 18 months, an experience yet to be had since the Great Recession.

Several unfavorable market conditions are at work to keep home sales volume in check going into 2022:

- the weakest homebuyer demographics in 15 years;
- failed savings for a *down payment* as high rents squeeze potential first-time homebuyers out of saving;
- buyer borrowing power no longer enlarging the funds they can borrow as interest rates inevitably rise, reducing funding for purchase-assist financing and dampening property prices;
- the public's increasingly anti-business and pessimistic attitude about American economics, wealth inequality and national politics no matter the outcomes; and
- tightened loan standards as lenders are forced to apply forgotten fundamentals of sound mortgage lending practices (20% down payment on non-FHA/private mortgage insured loans, lower income ratios, risk-free credit scores and full documentation of income, funds and collateral value).

SFR brokers and agents looking to supplement their income while they wait for the next boom might consider adding SFR-related services. Those that do add related services will restructure their practice as all-service brokers. To remain solvent and grow internally, brokers will integrate transaction-related services into their office operations

These services may include:

- *escrowing* their in-house transactions under the broker's license;
- entering into or expanding *property management* services (a recession-proof real estate niche);
- farming absentee owners of rented and unrented property to locate property suitable for buyer clients rather than rely on MLS publications to locate property;
- locating and negotiating equity purchases for investors from SFR sellers-in-foreclosure who have a positive equity or the chance of a short sale discount;
- specialized sales and leasing (in a particular type of commercial property, other branch locations and alternative marketing approaches);
- providing mortgage loan broker services to originate both consumer and business mortgages negotiated to be made by institutional and private lenders, with emphasis on business mortgages secured by any type of real estate (no mortgage loan origination (MLO) endorsement or Nationwide Mortgage Licensing System (NMLS) registration required);

Trends to be concerned about

The competitive broker

- arranging carryback financing and mortgage assumptions on property sales in which sellers have equity and new mortgages are unavailable or unreasonably priced (plus buying and selling those carrybacks);
- negotiating *options to buy* for speculators, renovators and builders;
- exchanging properties with equities to help owners avoid profit taxes and relocate their wealth held in real estate; or
- using barter of client’s goods and services and barter credits in lieu of greenbacks, etc. to buy, sell and rent property.

In a change of thinking, brokers need to insist that prospective buyers and tenants commit themselves to exclusive representations by the broker and their agent to locate a home (or other property).

Buyers need to learn to enter into exclusive right-to-buy listing agreements, *employing* brokers and agents just as sellers do. This will ensure time spent with a buyer produces a closing and a fee (paid directly from escrow to the buyer’s broker and not first disbursed to the seller’s broker). [See **RPI** Form 103]

Chapter 5.1 Summary

California home sales volume fluctuated from year to year throughout 2009-2020, but overall remained flat.

In 2021, home sales volume increased significantly, fueled by homebuyer fear-of-missing-out (FOMO), record-low interest rates and stimulus boosts. However, as the effects of stimulus wane and interest rates level and rise, 2022 will experience a downward trend in sales volume, anticipated following the expiration of the foreclosure moratorium.

The housing market won’t begin a consistent recovery until well after the need for government intervention and the pandemic response have ended, a timeline which continues to shift. Then, California’s housing market will need to emerge from the underlying recession and recover the historic job losses of 2020, a recovery not likely to even begin until around 2023-2024.

Chapter 5.1 Key Terms

bumpy plateau recovery	pg. 80
real estate owned property	pg. 81

Factor 6: Renting: the alternative to homeownership



Rent: the requisite to property value



After reading this chapter, you will be able to:

- understand how rent influences property valuations;
- quickly approximate fair market value; and
- distinguish between actual and implicit rent.

capitalization rate (cap rate)

**gross revenue multiplier
(GRM)**

implicit rent

income approach

net income multiplier (NIM)

price appreciation

The rent a property commands is fundamental to the setting of that property's value, called **fair market value (FMV)**.

For property valuation purposes, rent is categorized as either:

- the *gross operating income*, analyzed based on a **gross revenue multiplier (GRM)**; or

Chapter 6.1

Learning Objectives

Key Terms

**Rent
determines a
property's fair
market value**

gross revenue multiplier (GRM)

Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

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.

net income multiplier (NIM)

The property's price as a multiple of the net operating income.

- the net *operating income (NOI)*, analyzed based on a **capitalization rate (cap rate)** or **net income multiplier (NIM)**.

NOI is the total revenue remaining after deducting operating expenses from rents actually received as gross operating income.

Determining a property's value using the GRM or cap rate is called the **income approach**. The *income approach* historically is applied to limit the price a buyer will pay and a mortgage lender will lend on a property. However, when the current cost to replace the property or the price to acquire comparable existing properties is less than the value set by the income approach, these other methods are used to further limit the FMV.

With the income approach to valuation, the amount of rent a property generates is converted into that property's *FMV* by applying an appropriate cap rate for real estate investments to the NOI. Cap rates used for businesses are conceptually and economically inappropriate for application to real estate investments. Nevertheless, Wall Street money managers have erroneously applied business rates to rents and mortgages during the past several years.

Wall Street banker schemes include *real estate investment trusts (REITs)* and *adjustable rate mortgages (ARMs)*. ARMs are bundled into pools and sold as fractional participations in mortgage backed bonds (MBBs). [See Chapter 13: Stock market and Factor 7: Mortgages]

Calculation of approximate value

The *rule of thumb* for a quick calculation of an income property's approximate value has historically been to multiply the monthly scheduled rent by 100. Scheduled rent is the amount of rent anticipated to be received for all units if currently occupied.

Approximate value is calculated by multiplying the scheduled annual rents by a factor of 8.3. These rules are applied to see when the price asked for a property is reasonably related to the property's likely value, and thus worthy of making an offer to buy or entering into a *due diligence investigation*.

From 1999 to 2007, income property values in most of California defied any such analysis with prices artificially soaring to nearly 200 times monthly rents. The return to the reality of 100 as a multiplier brought on by the 2008 recession was brutal, especially for REITs with properties in California. However, by 2016 prices on low-tier priced housing were back to the 2007 level of around 200 times monthly rents, due mostly to nominally low interest rates on FRMs.

income approach

The use of a property's rental income to set its value.

Actual or implicit rent is the price for use

Rent is the price paid (or implicitly paid) for the occupancy and use of space, whether the user-occupant is a tenant or an owner. A tenant pays actual rent, while an owner occupying their property is charged with paying **implicit rent** (to themselves as the owner).

Implicit rent is the dollar amount of the value the owner receives by occupying the space themselves, be it shelter as the owner's residence or to house their trade or business. Implicit rent is an amount equivalent to the rent a tenant will pay to rent the same space.

implicit rent

The value of an owner's use of their property to house themselves or their business.

Further, tenants set rents, not landlords. Typically, tenants can afford to pay between 31%-38% of their income as rent to a landlord. As wages paid to local employees rise, rents also rise since the employee has more money to spend. Homeowners can afford to spend the same percentage of income on principal and interest payments to a mortgage lender and carrying costs of the property.

The exception to this rule continues to grow in 2021, as rents soar beyond local incomes in most parts of California, including Los Angeles and San Francisco. In turn, tenants spend more of their income on rent to maintain the same standard of living and have less to spend on other goods and services that contribute to local economic growth. The issue is a supply-demand imbalance and will only be fixed by more multi-family rental housing built in these most desirable parts of coastal California. [See Factor 10: Construction]

Lowering rents to attract tenants to rent vacant units initially cannibalizes tenants from other rental properties, a zero-sum game. Eventually, increases in the local population and job openings help fill up vacant units (residential and commercial) and reduce inventories of unsold properties. Also, long-planned intervention by the Federal Reserve (the Fed) caused mortgage rates to rise beginning in 2017, and while interest rates have briefly and dramatically fallen back as the Fed fights the effects of the 2020 recession, interest rates will resume their upward trend in 2023 for the next two-three decades. When rates remain elevated for sufficient time, they will drive wage earners and businesses toward rental properties and away from ownership. [See Factor 17: Monetary policy]

Landlords can only watch and respond

Without sufficient new construction for a growing population, availability of all types of housing and commercial property runs short of the local population's need for space. Until starts catch up, landlords are able to raise rents beyond 31%-38% of a wage earners' income, properly called **price appreciation** since it is not the product of consumer inflation. This is the situation in 2021 for much of California, especially in inland areas which continue to see residential rent increases despite the economic impacts of the 2020 recession.

price appreciation

Any increase beyond the rate of consumer inflation above the price paid for property experience by the owner on its resale.

This move will bring landlords excess profits for a limited time. Soon the excess earnings will spur the inevitable ruinous competition from builders. When rents are high enough, valuations based on rents then justify the cost of new construction. Without new construction, which is harshly restricted by **zoning regulations**, investors convert hotel space into condos, as was seen in the early '90s, and tenants orchestrate rent control ordinances, as occurred in the early '80s, and the price of property and rent will bubble.

Mortgage rates compete with rents affecting ownership

Rent charged by property owners is the economic equivalent of *interest rates* charged by money lenders. Both are a return for letting/lending an asset; one being real estate, the other cash. Both assets by agreement are to be returned (to the Rentier). Thus, rent charged to tenants by landlords is in direct competition with the interest paid by buyers on **fixed rate mortgages (FRMs)** made by lenders.

Tenants who wish to buy and occupy comparable space as an owner leave vacant rental space behind in the turnover. Builders, mortgage lenders and sales agents strive daily to convert tenants into owners. Their goal has been sold to Congress as being good for the country (but not very good by 2008 for *Freddie Mac* and *Fannie Mae* and the other third of the mortgage market lenders or negative equity homeowners).

The coupling of rent and mortgage payments as competitors for the dollars a user of property has to spend on occupancy is straightforward:

- a landlord expects a creditworthy tenant to pay a rent amount no greater than 31%-38% of the tenant's gross income; and
- a mortgage lender expects a creditworthy owner/occupant to pay monthly interest (and a de minimis amount of principal) on a maximum FRM and property carrying costs equal to 31% to 38% of their gross income.

These are nearly identical standards for the monthly out-of-pocket cost of occupancy; one applied to wage earners by landlords, the other applied to wage earners by mortgage lenders.

Recessionary pricing competes with rents

A further complication for rent stability during a recession is the accompanying *fall in the price of properties*. Property prices fall normally during a routine business recession. When prices drop enough, tenants benefit by becoming owners, since their mortgage payments will be lower than the rent paid by a tenant.

Several other factors influence the future trend in rents. These factors include local changes in population density (usually through improved zoning), foreclosure rates, vacant single family residences (SFRs) and condos, property values, wages, employment, migration/immigration, social mores, rent control, rental age population and household formations.

The rent a property commands is fundamental to the setting of that property's value, called fair market value (FMV). The rule of thumb for a quick calculation of an income property's approximate value has historically been to multiply the monthly scheduled rent by 100.

Rent is the price paid (or implicitly paid) for the occupancy and use of space, whether the user-occupant is a tenant or an owner. A tenant pays actual rent, while an owner occupying their property is charged with paying implicit rent (to themselves as the owner).

capitalization rate (cap rate)..... pg. 86
gross revenue multiplier (GRM) pg. 86
implicit rent pg. 87
income approach pg. 86
net income multiplier (NIM)..... pg. 86
price appreciation pg. 87

**Chapter 6.1
 Summary**

**Chapter 6.1
 Key Terms**

Chapter 6.2

Renting and owning across counties

Learning Objectives

After reading this chapter, you will be able to:

- anticipate the future of rental vacancies across California; and
- understand how homeownership rates vary across California counties.

Key Term

Generation Y (Gen Y)

Generation Z (Gen Z)

Are rentals the future of California real estate?

As **homeownership** and **rental vacancy** rates decline in counties across the state, a change in the housing market is on the horizon. California's future housing market will be determined by jobs, construction and foreclosure rates.

Figures 1 and 2 track the rate of change in homeownership both statewide and in the largest counties. The remainder of households rent.

Figure 3 tracks the rate of *rental vacancies* by county since 1993. Rental vacancies tend to rise in times of increased homeownership and excessive residential construction. Dark bars indicate periods of recession.

Future vacancy rates will be influenced by:

- current vacancy rates;
- regional foreclosures;
- regional job performance; and
- residential construction numbers.

Renting into the future

At its bottom, 10% of California homeowners shifted from homeownership (in 2005) to rental property (in 2016) for their shelter. A few years into the economic expansion, and the homeownership trend has reversed, having bottomed at 53% in 2016, peaking at 56.0% in 2020. The homeownership rate is set to decline in 2022, as the expiration of the foreclosure moratorium causes California's seriously delinquent homeowners to finally face a forced sale, or foreclosure.

This increased reliance on rentals follows on the heels of the historic spike in homeownership during the Millennium Boom. [See Figure 1 and 2]

Favorable public attitudes about homeownership climbed for about 60 years into the early 2000s. Then, in quick succession, we experienced a punch up in sales volume, a pricing bubble, a recession and a once-in-a-lifetime financial crisis.

In the aftermath, homeowners have found a home cyclically fails to be a reliable piggy bank (or ATM). They learned deregulated and thus unregulated mortgage lending brought on their losses for the lack of adequate consumer protections by governments.

Today, many homeowners are still recovering from the financial chaos, their balance sheets literally destroyed. The renter population has swelled, as fewer prior homeowners are able to buy after losing their homes. And fewer renters desire to be homeowners due to the negative taste left by the financial crisis. Eventually, in the next decade, all these negative aspects of homeownership will be generally forgotten or simply overlooked.

Consider a former California homeowner who lost their property to foreclosure in the days following December 2007, the beginning of the 2008 recession and financial crisis. This owner, like 900,000 other Californians following the recession, lost their job and suffered the corresponding loss of income. Others were simply unable to make payments when the time came to fully amortize their inherently deceptive *hybrid adjustable rate mortgages (ARMs)*.

Financially unable to buy a replacement home to house their family, our homeowner moves into a comparably sized SFR rental property in the same school district. The rental rate is one-third of the family income. Better yet, the rent is less than half their prior mortgage payment, a typical condition. Their credit score is now too damaged by the foreclosure (or short sale) to qualify for purchase-assist financing to buy a replacement home even if they wanted to return to ownership.


So, for the next few years the family will live in a rented home without the responsibilities imposed by ownership. This prior owner and others subjected to foreclosure or short sale have forfeited the tattered American Dream of homeownership in their housing turnover for the convenience, peace of mind and financial security (deleveraging) of renting.

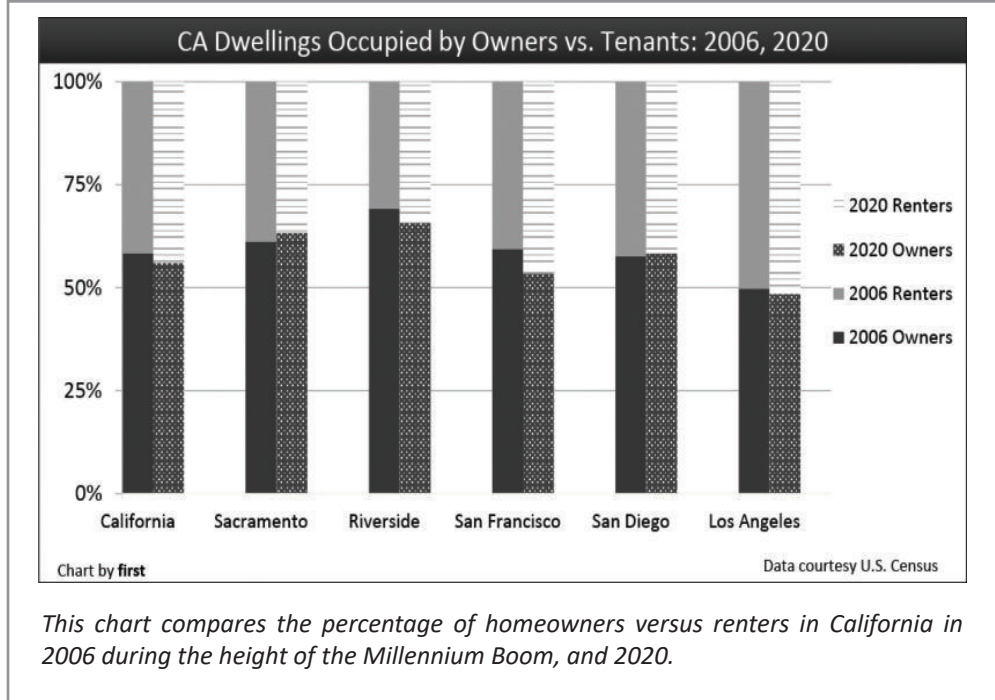
This situation is now a full-blown reality for homeowners across California. As of 2020, California has one of the lowest homeownership rates in the nation at 56.0%.

Rentals as a percentage of all housing are highest within high-density metropolitan areas, especially in cities like San Francisco, San Diego and Los Angeles. On the other hand, there are areas of traditionally high homeownership, like Riverside/San Bernardino and Sacramento. These regions have maintained a less expensive lifestyle focused on suburban housing, even in the difficult years following the 2008 recession.

Recovering from foreclosure: to own or to rent

Figure 1
CA Dwellings Occupied by Owners vs. Tenants: 2006, 2020


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



This chart compares the percentage of homeowners versus renters in California in 2006 during the height of the Millennium Boom, and 2020.

Jobs' impact on homeownership

Generation Y (Gen Y)

The current generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

Generation Z (Gen Z)

The up-and-coming generation of first-time homebuyers, consisting of individuals born in the late-1990s and the 2000s.

Future homeownership rates depend largely upon the coming wave of first-time homebuyers. These homebuyers are typically aged 25-34. Often, they will purchase a low-tier or mid-tier SFR for their first homes. Looking forward, the coming generation of first-time homebuyers will mostly be made up of members of **Generation Z (Gen Z)**, much of **Gen Y** having missed their peak first-time homebuyer years in the decade following the 2008 recession. [See Factor 15: First-time homebuyers]

Severe job loss, however, has delayed the time for homeownership in almost every region of California. First-time homebuyers are declaring themselves financially unable, or just plain unwilling, to purchase a home in spite of cyclically low mortgage rates. The more realistic age of today's typical first-time homebuyer is increasing to 30-40 years.

As jobs continue to return, they are likely to grow fastest in city centers, where housing has been most desirable over the past decade. Expect to see rental vacancies at their lowest in these high-demand metro areas.

Future rental construction will increase

An increase in rental activity is naturally followed by an increase in rental construction. As vacancy rates are now below historic norms (generally near 5%, at 3.8% in 2020) and rents rise beyond the rate of inflation, multi-family construction will return to keep rents and prices down. Again, zoning limitations may interfere, which will cause rents to rise more quickly than the rate of consumer inflation (and wages). This will squeeze out tenants and slow the rise in the absorption rates for office and industrial buildings.

Apartment and condo construction was at its lowest in 2009. Multiple family construction has now begun to increase in coastal regions more rapidly than

statewide SFR construction due to high occupancy rates. Thus, builders have little competition from existing rentals to meet the increasing demand for centrally located rental units of higher quality.

Construction for SFRs, on the other hand, has increased much more slowly. Builders have little incentive to build, as SFR vacancies were level with their historical average of around 1.2% for years. Homeowner vacancies dipped below this historical level during the last recovery and are now near historic lows, at 0.77% as of 2020.

Today's low SFR vacancy rate is mainly due to the eviction and foreclosure moratorium that has kept homeowners housed in 2020, despite the historic job losses that have left many homeowners unable to make mortgage payments. Further, many would-be sellers have chosen not to list during the pandemic, pushing multiple listing service (MLS) inventory to new lows.

Counties like **Riverside** were at the center of California's housing boom in the early 2000s. During the so-called Millennium Boom, homes were built and sold faster than was sustainable in the long term. Riverside's homeownership rate jumped from 62.5% to 68% between 2000-2005, pulling the state's rate of homeownership up with it. [See Factor 25: Regional housing indicators]

Those homeownership gains were illusory. From 2005 to 2014, Riverside's rate of homeownership dropped significantly, seven percentage points below its level at the peak of the boom. However, it has also been one of the quickest to recover and as of 2020 is the metro area with the highest level of homeownership in the state.

With every statewide trend, of course, there are exceptions. San Francisco County experienced a less noticeable dent in homeownership during the recession but has since gradually declined to near 53% in 2020. [See Figure 2]

San Francisco's upside-down homeownership trend is due to the general lack of SFR construction and prevalence of high-tier properties in much of the West Bay Area. Further, their population was less susceptible to foreclosure during the aftermath of the 2008 recession due to strong local employment in the information technology industry. [See Factor 25: Regional housing indicators]

Interestingly, the rate of homeownership has fallen most consistently in highly urbanized Los Angeles, which has demonstrated a downward trend in homeownership since 2005. [See Factor 25: Regional housing indicators]

Many large southern coastal cities remain examples of past suburban sprawl and inefficient zoning. They have, however, begun to reorganize to a more sustainable, centralized model of higher density urban living.

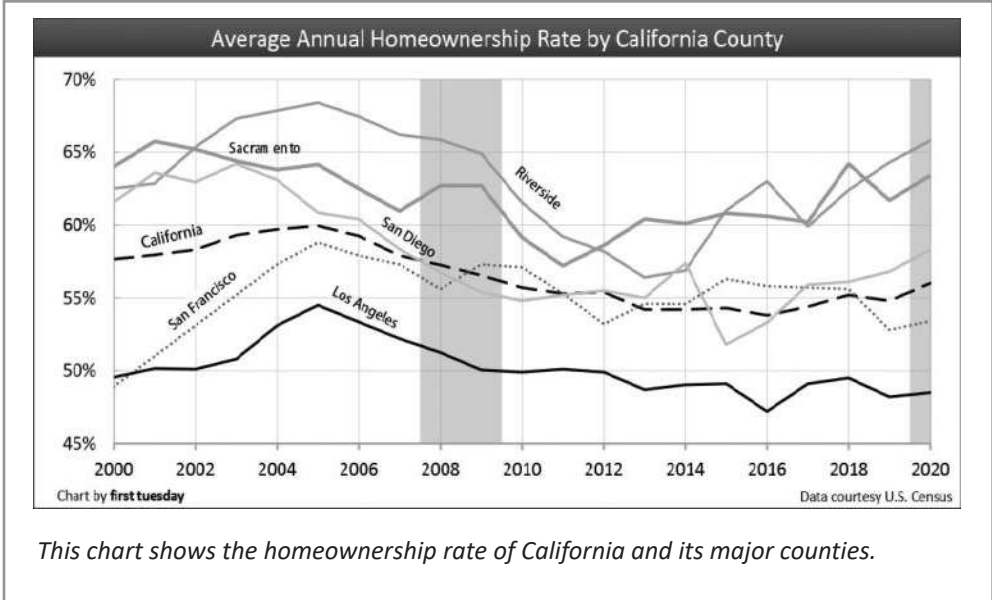
Those who willingly choose to rent now find they have competition from **renters-by-necessity**. With this shift in housing demand, residential rental properties are now dominating the housing market.

Homeownership by county

Homebuyer demand shifts

Figure 2
Average Annual Homeownership Rate by California County

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



Renters-by-necessity are foreclosed-out homeowners and forced-out short sellers. Presently, they are left financially unable to purchase a home. They have no savings, damaged credit scores and an enduring emotional aversion to homeownership — at least in the foreseeable future.

Some who were burned by short sale or foreclosure will eventually return to homeownership, but not likely more than 10%-15% of this population within the next 10 years. They will be joined by first-time homebuyers who have put off homeownership. This return will occur when their jobs, savings, deleveraging, credit scores and confidence in the economy permits them to do so.

Meanwhile, bedroom cities in the inland suburbs are replete with vacant SFRs, as those who lost their home are most likely to end up renting in urban centers closer to their jobs. Homes in all price tiers are being acquired by buy-to-let investors who are intent on collecting them solely for the value they present in long-term monthly rental income.

On the other hand, speculators acquiring real estate generally do so only for growth in value. They prefer to sell, as do day traders, for a quick profit and without the inconvenience of a tenant. In the absence of willing homebuyers, many syndicators and speculators have altered their resale expectations, hybridizing their holding plans to include renting the properties to cut their carrying costs as they wait longer to sell.

Vacancies by county

Rental vacancies are driven by varying local demand. The key factors influencing vacancies are the local jobs situation and the local attitude toward SFR homeownership and renting, which change over time. [See Figure 3]

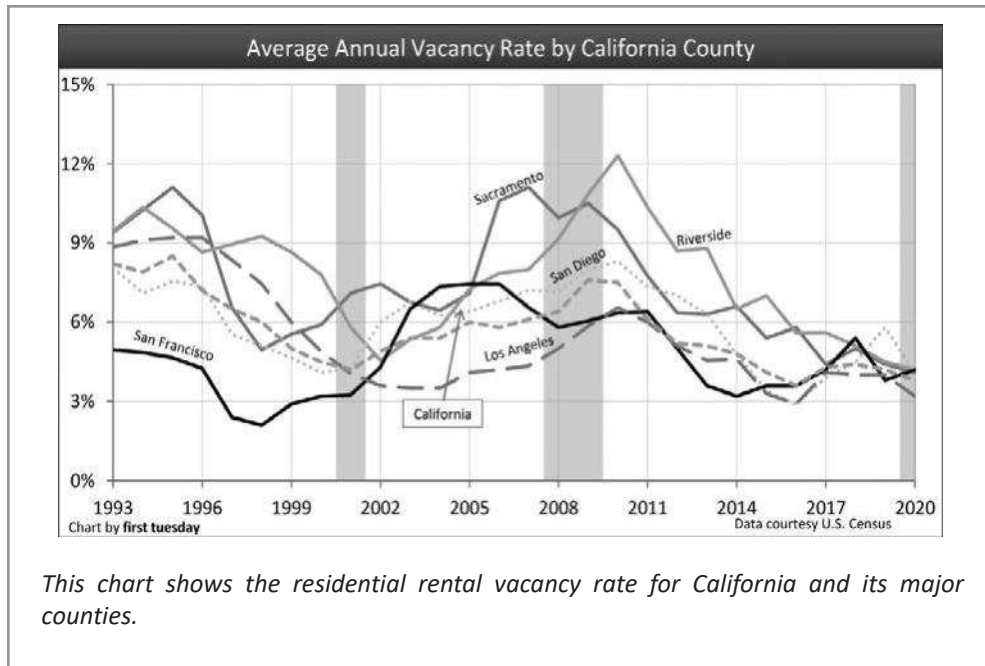


Figure 3

Average Annual
Vacancy Rate by
California County

**ONLINE UPDATE**

Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.

For instance, Sacramento experienced massive vacancies during 2006 into the early days just before the beginning of the 2008 recession. Since then, the area has seen rental vacancies drop dramatically. The many foreclosed homeowners in that region have taken up available rental inventory.

Meanwhile, Riverside has consistently had the highest rental vacancy rates in California from 2006 to present. This is due to insufficient new renters to fully occupy the vastly overbuilt SFRs in these areas.

The average rental vacancy rate declined to 3.8% in 2020, well below historic norms. Today's low vacancy rate stems directly from 2020's eviction moratorium, which has allowed tenants to remain in place due to the global pandemic, whether or not they have the ability to pay. The highest rental vacancy rate in 2020 was 4.2% in Riverside and San Francisco. The lowest was 3.2% in Los Angeles.

Rental vacancies will continue to linger below historic norms even after the eviction moratorium ends in 2021. That's because California has experienced a housing shortage for years, with very little residential construction completions to add to the inventory. State-initiated legislative efforts to add to the housing stock have focused on encouraging more multi-family construction. However, social distancing and tightening lines of credit are holding builders back during today's recession, which will combine to put downward pressure on multi-family starts in 2020-2023.

Trends point to an increase in rental demand in the upcoming years throughout California. While some regions, especially Riverside, will take a longer time to shift from the 1950's standard of suburban SFR homeownership,

Future rental vacancies

The rise of rental property

rental property is poised to lead the real estate recovery. Even in counties with higher than average homeownership rates, rentals will emerge as significant profit centers for landlords and property managers.

Agents in urban areas need to consider adding *property manager* to their title, as demand for this skill will undoubtedly rise throughout this decade. Also, keeping informed about the local construction and job trends will help agents prepare for future demand in their communities.

SFR homeownership is nowhere near becoming obsolete. But its 30-year dominance into 2005 is definitely a relic of the past.

**Chapter 6.2
Summary**

As homeownership and rental vacancy rates decline in counties across the state, a change in the housing market is on the horizon. As of 2020, California has one of the lowest homeownership rates in the nation at 56.0%.

In 2020, homebuyer demand outpaced supply, causing homebuyer competition and prices to soar, despite the recessionary environment. Fueling the rise were record-low interest rates, which boosted buyer purchasing power an equivalent amount. However, California’s homeownership rate is expected to reverse course in the next couple of years, having reached a peak for this housing cycle. As the foreclosure moratorium ends in 2021 and distressed sales flood the market, homebuyers will become more cautious, allowing home prices to decline. Homeownership will find greater support once jobs begin to return, likely around 2023.

**Chapter 6.2
Key Term**

Generation Y pg. 92
Generation Z..... pg. 92

Renting versus buying: the GRM as a measure

Chapter 6.3

After reading this chapter, you will be able to:

- calculate and apply the gross revenue multiplier (GRM);
- understand the financial scope of a property purchase; and
- appreciate the many costs of property ownership.

gross revenue multiplier (GRM)

One good way, but by no means the only way, to decide whether you are better off financially renting or buying a single family residence (SFR) is to consider the property's *price-to-rent ratio*.

This rule-of-thumb, more commonly referred to as the **gross revenue multiplier (GRM)**, is used to quickly evaluate the value of a property. A home's GRM is calculated by dividing the asking price for a residence by the annual rent it or a comparable property commands. [See Figure 4]

When considering whether to purchase or lease a home (or a comparable property), the GRM is said to tip in favor of leasing at 20 times a property's annual rent, a figure suggested by David Leonhardt, writing for the New York Times in 2010.

As perceived, an asking price more than 20 times a property's annual rental value means renting is a better bet than owning. Likewise, the reporter claims that when the price of a property dips below 20 times its annual rental value, purchasing a home will be the more prudent financial decision. Any variation in mortgage rates, it is argued, will inversely alter this ratio; higher rates, lower GRM.

In many high-end neighborhoods and communities, it makes more financial sense to rent than to buy — based on the GRM of 20, or even a more prudent 14 for that matter. This is the situation that exists in coastal neighborhoods of Orange County, San Diego and San Francisco. Further, it sometimes makes more sense to rent than buy, particularly in California's low-tier housing market, which has seen significant price increases since 2012 due to a supply-demand imbalance. [See **RPI** Form 320-4]

Learning Objectives

Key Term

A comparison of expenditures to rent or own an SFR

gross revenue multiplier (GRM)

Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

Form 320-4
 Buy-Versus-
 Rent After-Tax
 Analysis
 Page 1 of 2

BUY-VERSUS-RENT AFTER-TAX ANALYSIS

NOTE: This form is used by a buyer's agent when counseling a potential homebuyer who currently rents their residence, to present an estimate of the income tax reduction and equity buildup likely to be experienced from homeownership.

DATE: _____, 20____, at _____, California.
 PREPARED FOR: _____
 PREPARED BY: _____ CalBRE #: _____
 Broker's name: _____ CalBRE #: _____
 Phone: _____ Cell: _____ Email: _____

This cost comparison involves the ownership costs of property known as _____ and
 the rental costs for the same property, or property now rented by the homebuyer known as _____.

Source of the information used in this analysis: _____

Note: Homeowners need to itemize their personal deductions and list their deductible ownership expenses to experience a reduction in their income tax liability.

1. The costs of renting:

1.1	Monthly rent payment	\$ _____
1.2	Utilities paid monthly (gas, electricity, water, trash, etc.)	\$ _____
1.3	Tenant insurance premium..... Annual \$ _____ Monthly \$ _____	\$ _____
1.4	Monthly parking/storage charge	\$ _____
1.5	Recreation or fitness facility monthly cost	\$ _____
1.6	Other monthly occupancy and tenant expenses	\$ _____
1.7	TOTAL BEFORE-TAX expenditures for renting – monthly.....	\$ _____
1.8	Tax savings: California Renter Tax Credit:..... Annual (-)\$ _____ Monthly (-)\$ _____	\$ _____
1.9	TOTAL AFTER-TAX expenditures for renting – monthly.....	\$ _____

2. The costs of homeownership (exclusive of acquisition and transactional costs):

2.1	Price of the property	\$ _____	
a. Property tax rate: <input type="checkbox"/> 1%, <input type="checkbox"/> 1.1%, <input type="checkbox"/> 1.2%.			
b. Property taxes			Annual \$ _____ Monthly \$ _____
2.2	Mortgage principal amount (include upfront MIP if FHA).....	\$ _____	
a. Interest rate: _____%			
b. Mortgage payment (principal and interest) – monthly..... (Online amortization calculator)			\$ _____
c. Mortgage default insurance monthly premium: <input type="checkbox"/> PMI, <input type="checkbox"/> MIP.....			\$ _____
2.3	Assessment bond principal amount (streets/solar).....	\$ _____	
a. Interest rate: _____%			
b. Bond payment.....			Annual \$ _____ Monthly \$ _____
2.4	Nondeductible carrying costs of ownership [See RPI Form 306]:		
a. Homeowner insurance premium			Annual \$ _____ Monthly \$ _____
b. Gas and electricity – monthly.....			\$ _____
c. Water, etc. – monthly.....			\$ _____
d. Trash and sewage – monthly.....			\$ _____
e. Repair and replacement maintenance monthly			\$ _____
f. Homeowners' association (HOA) monthly payment.....			\$ _____
g. Solar panels lease payment monthly.....			\$ _____
h. Pool/Spa maintenance monthly			\$ _____
i. Yard/lawn care monthly			\$ _____
j. Maid/Housekeeping			\$ _____

----- PAGE 1 OF 2 — FORM 320-4 -----

The influence of the American Dream

The typical homebuyer is *financially naïve*, having no idea what price to pay for property. They have other pressures driving them to buy than financial wisdom and property evaluation. A common pressure comes from friends and relatives who continuously beat the drum of homeownership until it becomes an implicit belief, no matter what financial circumstances and market conditions dictate. Government housing policy and lenders, builders and most agents just add noise to the decisions surrounding homeownership, little help to the public.

However, if we want a more stable housing market in California, it's important to help homebuyers purchase their homes for the right reason — as a wise financial decision when providing for their shelter.

----- PAGE 2 OF 2 — FORM 320-4 -----

k. Other monthly home expenses \$ _____
 l. Total monthly nondeductible carrying costs \$ _____
 2.5 **TOTAL BEFORE-TAX** ownership expenditures \$ _____
 3. **BEFORE-TAX DIFFERENCE** in monthly expenditures of owning versus renting (+)(-) \$ _____
 4. **MONTHLY TAX SAVINGS** analysis:
 4.1 Deductible ownership expenses – monthly:
 a. Mortgage interest \$ _____
 b. Streets/solar assessment bond interest \$ _____
 c. PMI/MIP \$ _____
 d. Property taxes \$ _____
 e. Total monthly deductible ownership expenditures \$ _____
 f. Household's tax rate : 10%, 15%, 25%, 28%, 33%, 35%, 39.6%.
 4.2 Savings from reduced income taxes – monthly: (-) \$ _____
 4.3 **TOTAL AFTER-TAX** expenditures for ownership – monthly \$ _____
 5. **AFTER-TAX DIFFERENCE** in monthly expenditures of owning versus renting (+)(-) \$ _____
 6. **ADDITIONAL YEAR-OF-PURCHASE TAX SAVINGS** for mortgage origination:
 6.1 Mortgage origination fees \$ _____
 6.2 Prepaid interest for month of closing \$ _____
 6.3 Total year-of-purchase mortgage origination deductions \$ _____
 6.4 Household's tax-bracket rate _____
 6.5 Additional one-time tax savings for year of purchase \$ _____

BUY-VERSUS-RENT ANNUAL SUMMARY

1. **BEFORE-TAX:**
 1.1 **TOTAL** annual out-of-pocket difference – ownership versus renting (+)(-) \$ _____
 2. **AFTER-TAX:**
 2.1 **TOTAL** annual out-of-pocket difference – ownership versus renting (+)(-) \$ _____
 2.2 Additional one-time tax savings for the year-of-purchase \$ _____
 2.3 **TOTAL** out-of-pocket difference during first 12 months (+)(-) \$ _____
 3. **WEALTH FACTOR OF HOME EQUITY BUILDUP:**
 3.1 Amortized principal reduction at 10 years (Online amortization calculator) \$ _____
 3.2 Mortgage principal reduction as savings (10-year annual average) \$ _____
 3.3 Home value increase (3.5% annual growth) \$ _____
 3.4 **TOTAL** annual home equity buildup (10-year annual average) (+) \$ _____
 4. **ANNUAL NET FINANCIAL BENEFIT** of homeownership versus renting \$ _____

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Form 320-4
 Buy-Versus-Rent After-Tax Analysis
 Page 2 of 2

Societal purchasing pressure contributed to the swell of homeownership in the mid-2000s when the GRM was over the top in essentially all California neighborhoods. Minorities, the urban and suburban poor, have been especially hard hit by ill-informed advice and encouragement to “move on up” by buying a home, not renting.

Speculation by novices also was present. Hopefully reselling at a profit when adjustable rate mortgages (ARMs) reset appeared to be a certainty adding homes to the sales inventory.

Figure 4
Gross Revenue Multiplier (GRM)

Gross Revenue Multiplier (GRM)	20 X	14 X
The property's rental value	\$2,000 mthly (\$24,000 annual)	\$2,000 mthly (\$24,000 annual)
The property's purchase Price	\$480,000	\$336,000
FHA downpayment	\$16,800	\$11,760
Monthly payments	\$2,630 (5.5% \$463,200 loan) (\$100,000 annual income)	\$1,841 (5.5% \$324,240 loan) (\$72,700 annual income)
Taxes, insurance & maintenance	\$670	\$505
Tax benefits	-\$500	-\$385
Total monthly expenditures	\$2,800	\$2,000
Percent of gross income	33% (\$100,000 annual income)	31% (\$72,700 annual income)
Comparison to renting (annual cost)	-\$9,600	Break even
Ownership Benefits		
Annual loan reduction	\$6,240	\$4,370
Annual price inflation (2%)	\$9,600	\$6,720
Annual gain/loss versus renting the same property	\$6,240	\$11,090

Table by Realty Publications, Inc.

Social amenities, the neighborhood and beyond

A number of *social amenities* — externalities to the property in economic parlance — are favorably associated with owning a home:

- the appearance of family stability;
- a safe investment (“as safe as a home,” it used to be said);
- activism for the benefit of one’s community and civic responsibility;
- involvement in local politics;
- neighborhood collaboration to reduce crime and improve appearances; and
- investment in property aesthetics.

The values of these amenities are in addition to direct financial effects, such as:

- meaningful income tax savings for the wealthier through *itemized deduction* of property taxes and mortgage interest;
- *implicit rent*, the financial gain received for using the residence owned by the occupant without actually paying rent, offset by mortgage payments and the opportunity cost of investing in other assets;
- *equity buildup* due to amortized principal payoff, property improvements and any property’s asset value inflation; and

- neighborhood appreciation lifting property value beyond the rate of *consumer inflation* due to increased desirability of the location.

However, to cite only the benefits of ownership is misleading. Many generally unspoken consequences come with the ownership of a home. While the purchase of a home may promote a “liberated” feeling, homebuyers often ignore at their peril:

- the grip of physical obsolescence brought on by time past;
- the expense of maintaining a property; and
- the risk of resale and mortgage conditions at the time of turnover.

A home exposes its owner to financial risk when the need inevitably arises to extract the wealth locked up in a home’s equity. These risks have overwhelmed homeowners in California during the Great Recession. Mortgaged but positive equity California homeowners found themselves “house poor” with their earnings trapped in an asset rendered illiquid in the financial crisis or cut to zero value by the double edged sword of debt leveraging. Another 2.5 million more Californians found themselves in a worse situation, locked in by *negative equity*, a total loss and balance sheet insolvency.

Home values in California dropped dramatically after 2005 (as they typically do in normal business recessions, only more so this time due to the concurrent financial crisis). Thus, mortgaged homeowners had no way to access the wealth they had stored in their home.

As a result, they were unable to cover costly emergencies, or fund any planned future purchases, investments or family educational needs.

The known costs associated with owning a home remain largely unspoken.

First, the monthly payment on a maximum mortgage is not equivalent to the rent a tenant will pay to lease the same or a similar SFR. Implicitly, the financial lure of ownership for other than those in higher tax brackets is not significant unless the mortgage payment is considerably less than the rental value of the property.

The amount of a homeowner’s mortgage payment needs to be bundled with additional *ownership* and *operating expenditures* which come with the acquisition of any property:

- taxes;
- insurance;
- maintenance;
- replacement of structural components;
- HOA fees when the property is located in a common interest development (CID); and
- furnishings.

**A cost of
ownership
comparison:
just the facts**

**Additional
ownership
and operating
expenditures**

With the exception of furnishings, ownership and user expenditures such as water and trash are usually included in rent. The expenditures included in rent are especially distinguishable when the SFR under consideration is a condominium unit since the owner typically pays the HOA fees. [See **RPI** Form 306]

Even as prices are expected to decline in 2021 following the expiration of the foreclosure moratorium, prices are still not low enough in most low-, mid- and high- priced areas to make buying a better monthly deal than renting.

Editor's note — An exception exists in areas where rents are rising disproportionately fast, as in parts of Los Angeles.

Distortions will eventually appear between the costs of construction and resale pricing. This is another fundamental in the buy-or-rent decision that triggers excitement on the time-to-buy radar.

A true cost/ benefit analysis

To calculate a client's exact cost comparison of renting versus owning, particularly through tax savings, prepare the **Buy-Versus-Rent After-Tax Analysis** published by **RPI (Realty Publications, Inc.)**. [See **RPI** Form 320-4 accompanying this chapter]

In the form, enter the client's information about the:

- purchase price;
- property tax rate;
- utilities;
- mortgage information; and
- the homebuyer's current housing costs for comparison.

This interactive form will do the math for the client and their agent. The calculations assume a 3.5% annual gain in property value (an historical average), though the true property value will oscillate from year-to-year. The calculations also assume the homebuyer will own the home for ten years before selling.

Real homeownership numbers talk more loudly than broad assumptions and pro forma generalizations about:

- tax savings from interest deductions;
- equity buildup through mortgage amortization;
- an inflationary hedge; and
- appreciation profits.

Use of the form persuasively illustrates the benefits of buying by factual, written evidence. [See **RPI** Form 320-4]

Unfortunately, the *New York Times'* GRM of 20 times the annual rental value of an SFR is heavily skewed towards homeownership. Using a GRM of 20 will, in fact, lead potential homebuyers to believe that buying patently overpriced housing is a financially sound decision. At this GRM, it is not. [See Figure 4]

The cusp of a buy-or-rent decision historically is a GRM of around 14, if not lower. When a GRM is at or above 14 in a 5% mortgage environment, tenants may consider buying if they are motivated by pride of ownership or driven by an unshakeable belief that it is better to own rather than rent.

A great deal of sweat equity needs to be continuously invested in a property by the buyer to make financial sense at a GRM of 14 or greater. The buyer at a GRM of at least 14 needs to keep maintenance costs low enough to break even by matching their after-tax, out-of-pocket costs of ownership against the property's implicit rental value — their use of the property as a residence.

The price paid for an SFR at a GRM of 14 needs to initially increase more than 10% in value/price for an owner to resell and recover their principal investment, acquisition costs and costs of the resale.

This 10% figure includes approximately 2% transactional costs incurred to acquire the property. It also includes the costs to resell the property in the future, which is around 8% of the sales price. These resale costs also include:

- broker fees;
- escrow fees;
- closing costs; and
- fixer-up expenses associated with mitigating deferred maintenance (excluding the replacement of components of the property improvements).

The seller's transactional costs on a resale are often far greater in an average buyer's market since sellers need to be much more competitive.

In market conditions which favor buyers, sellers often pay up to an additional 6% of the price to cover the buyer's non-recurring and recurring closing costs. This is increasingly the case as mortgage rates rise.

Thus, a property has to appreciate in price by 10% to 15% just to get back the original down payment and the equity built up by the amortization of principal on the mortgage. Also note that this amount of appreciation does not include an annual return or inflation adjustment for lost purchasing power on the money invested.

The current outlook for inflation's future impact on the value of property is comparable to the post-WWII rate of increase throughout the 1950s and into the 1960s. This increase is limited to **consumer price index (CPI)** inflation at around 2%-3% annually after prices trough. While there will be intermittent price bounces when prices rise faster than the rate of inflation (as experienced

The GRM comparison

Costs included

in 2020), the historical mean price trendline always pulls prices back down to that yearly average increase in California of around 2.7% compounded. This 2.7% figure evolves from the rate of consumer inflation, increased California population and income growth.

Owners wait for inflation to do its magic

During the coming decade, as occurred for purchases after 1947 at the end of the Great Depression, a buyer will need to stay in the property for a minimum of six or seven years just to break even on a home purchase and resale. To break even, a buyer needs to have their down payment and principal reduction returned. This leaves them with no net gain on the money invested for a down payment on an upgrade in replacement housing. They are not at that time compensated for lost purchasing power on their invested dollars. Rising interest rates going forward will only add to this toll on pricing.

The market value of a SFR is based historically and fundamentally on monthly rents. For experienced income property investors, monthly rents represent roughly 1% of the property's value.

However, this 1% represents an annual GRM of 8.33, not the GRM of 20 the media reports for homebuyers. Investor pricing is less than the GRM of 14 we have given homebuyers as a ratio to guide the pricing of homeownership. These multipliers represent the likely rental value of a low to mid-tier SFR property in California. High-tier properties are pride of ownership affairs and have no relationship to rental value.

In all this analysis, do not overlook the evaluation of property based on its cost per square foot replacement value. The lesser of these values set by alternative evaluation methods is the basis for the maximum price a prudent buyer will pay for property.

Buyer's agents make better advisors when equipped to place their buyer in a home at the right price. Such is their duty. The buyer's agent needs to make it clear that buying is not always the right thing to do and now is not always the right time to buy.

The buyer's broker and their agents who are best able to care for and protect their buyers are aware of the various rent and pricing ratios — the GRM — and replacement costs of SFRs.

Be they investors, speculators, homeowners or tenants, those considering buying need to be informed whether a home is priced right. **The broker price opinion (BPO)** for property evaluation is best reached by analysis of data rather than a feeling of what the sellers need to get or might want for their properties.

One good way, but by no means the only way, to decide whether you are better off financially renting or buying a single family residence (SFR) is to consider the property's price-to-rent ratio. This rule-of-thumb, more commonly referred to as the gross revenue multiplier (GRM), is used to quickly evaluate the value of a property. A home's GRM is calculated by dividing the asking price for a residence by the annual rent it or a comparable property commands.

The amount of a homeowner's mortgage payment needs to be bundled with additional ownership and operating expenditures which come with the acquisition of any property:

- taxes;
- insurance;
- maintenance;
- replacement of structural components;
- HOA fees when the property is located in a common interest development (CID); and
- furnishings.

gross revenue multiplier (GRM) pg. 97

Chapter 6.3 Summary

Chapter 6.3 Key Term

Notes:

Factor 7: Mortgages



The ARM vs. the FRM



Chapter 7.1

After reading this chapter, you will be able to:

- understand a homebuyer's critical concerns about mortgage borrowing; and
- help your buyer client select and arrange compatible purchase-assist financing.

80-10-10 financing

adjustable rate mortgage

fair market value

installment sale

leveraging

return on investment (ROI)

speculator

Learning Objectives

Key Terms

A real estate mortgage's primary function is to provide additional capital for buyers and owners of real estate. As financing, a mortgage secured by a lien on real estate does not affect the owner's possession or operation of the real estate it encumbers (unless the lender's interest in the property as **collateral** becomes impaired or security device provisions limit the owner's use).

The real estate mortgage

A real estate mortgage appears as a *trust deed lien* (a security device) on title to the property described in the trust deed allowing the lender to enforce the mortgage by nonjudicial foreclosure.

However, a mortgage does affect a property owner's ownership rights. This is because its effects include the owner's risk of losing the property if the mortgage is not repaid as agreed in the lender's mortgage documents.

The mortgage has additional effects on the *ownership of income property* but not the property itself. A mortgage taken out to provide capital for assisting in the acquisition of an income property alters:

- the owner's rate of return on funds invested in the property (including the owner's cash contribution);
- the amount of net spendable income from the property; and
- deductions for adjustable gross income (AGI) tax reporting.

The owner also risks losing the property if the mortgage is not repaid as agreed, typically in the form of monthly payments of principal and interest.

The alternative to taking out a real estate mortgage is to negotiate seller financing when purchasing a property generally referred to as an **installment sale**. This type of financing involves a note carried back by the seller and secured by the property sold, extending the buyer credit to periodically pay the unpaid balance of the purchase price with accrued interest.

Similar to a real estate mortgage, possession and operation of the property are not affected by the carryback trust deed. The debt owed the seller on the note is merely a lien on the buyer's ownership of the property. As with any mortgaged property, the mortgage either:

- increases the **return on investment (ROI)** for the amount of cash contributed; or
- increases the risk the property (and their cash invested) will be lost to foreclosure.

This concept is called **leveraging**, the double-edge sword of possible greater returns or potential total loss.

Mortgages made to finance real estate transactions are classified as either *fixed rate mortgages (FRMs)* or *adjustable rate mortgages (ARMs)*.

FRMs provide stable, invariable long-term financing. The FRM interest rate is fixed for the life of the mortgage, an advantageous long-term financing arrangement given interest rates and capitalization rates will rise for the next 25 or so years. [See Factor 2: Interest rates]

The lender chooses the FRM rate based on the 10-year Treasury Note rate at the time the FRM is originated, adding a margin to the 10-year T Note for the lender's risk in originating the mortgage and servicing it. Historically, the margin has been 1.5%. However, the margin went to as much as double

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.

return on investment (ROI)

A measure of earnings in relation to capital invested.

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.

The invariable FRM

that in the years immediately following the Millennium Boom, indicating homebuyers continue to overpay for mortgages to cover the lenders' perceived risks. In the first quarter (Q1) of 2021, this spread had shrunk to just 1.4%, which means lenders cannot drop mortgage rates further without intervention from the Federal Reserve. [See Factor 17: Monetary Policy]

An FRM allows the owner to retain a hedge against future inflation, the *hallmark* of long-term ownership in real estate. Further, FRMs provide stability for future ownership since monthly payments are constant and the mortgages are typically fully amortized. Any **final/balloon payment** disrupts stability and greatly increases the risk of loss.

ARMs, on the other hand, do not have the characteristic elements of a real estate mortgage. *ARMs* are based on short-term rates designed for financing consumer products, such as cars, inventory, equipment, payroll and stock margins. Short-term rates can only rise for the next couple of decades, as the zero lower bound rate will not psychologically permit it to go down, only up.

The degree of instability created for ownership subject to an ARM is gauged by the range of periodic adjustments in the note rate and monthly payments agreed to in the note. The amount of the monthly payment on an ARM is reset constantly based on fluctuations in short-term interest rates: a most volatile and unpredictable variable which in no way parallels changes in a homeowner's wages.

The *risk of loss* associated with an ARM is unacceptable except for the most wealthy and sophisticated of investors. *ARMs* offer far too great a risk for homeowners relying on wages and salaries from employment – 99% of the population.

Short-term rates used to set the note rate in an ARM are harnessed to the Fed's fight against inflation and deflation. By forcing the rate up or down, the Fed makes it more (or less) costly for consumers to buy goods and services, and for businesses to finance their inventory and equipment, and retain ownership of property encumbered by an ARM.

Inconsistently, the ARM uses these short-term rates to set the cost of financing the continued ownership of the very real estate it encumbers. The natural consequence of coupling real estate ownership to short-term rates has always been and will continue to be higher foreclosure rates for *ARMs* than for *FRMs*. Worse, as rates inevitably rise in the future automatically lifting ARM note rates, the homeowner with an ARM will have less disposable income and the income property owner will see their ROI decline.

As a result, an ARM shifts the inflation hedge of long-term ownership and thus wealth from the owner to the lender. As short-term rates rise to fight inflation, they drive up the amount due monthly to the ARM lender, causing a shift in wealth from borrower to lender to occur. This shift in wealth by the

Unstable ARMs

adjustable rate mortgage (ARM)

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]



 [Click to watch](#)

Shift in wealth

speculator

A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.

The ARM lender gets the benefits of inflation

terms of the ARM note will periodically increase over the life of the ARM for the next few decades as we move away from the zero lower bound rates of 2020-2021.

ARMs are primarily permitted and created for the benefit of the lender. **Speculators** bent on flipping do sometimes benefit from the use of an ARM to leverage their cash into ownership of more or larger properties to be sold before the ARM adjusts or resets. But homebuyer occupants will inevitably lose the inflation hedge in the rising interest rate regime of the next two-to-three decades.

The lender reaps the benefits of any future inflationary increases in the value of the secured property (the inflation hedge). The lender receives the benefit of inflation since the short-term rate controlling the ARM rises with inflation. The rise in short-term rates automatically increases the rate of interest and monthly payments due to the lender – the shift in wealth to the lender. By another calculation, the dollar amount of this shift in wealth to the ARM lender represents the present value of future inflation-driven increase in the value of the property.

An ARM fits the needs of *speculators* perfectly. Initially, and for a short period of time, ARMs are low-cost mortgages, a sort of “free lunch.” Initial monthly payments are low, often based on **teaser rates** set near Fed inter-bank rates. [See Factor 2: Interest rates]

In ARMs originated in the past, the speculator typically had the option of continued low payments, which produce *negative amortization*. Negative amortization builds up the principal balance on the mortgage in lieu of out-of-pocket cash expenditures to cover carrying costs brought on by negative cash flow. Any additional cash investment reduces the ROI on the cash invested when the property is resold.

Government regulation of ARMs

Gatekeepers — brokers and builders — who police the entry of the public into the real estate market tend to want buyers to have access to ARM financing. This desire is patent: the earnings of brokers, builders and lenders are based on both sales volume and the dollar size of the property, not on the value of the services these providers render.

ARMs allow the lender to *lend more*, and put more money into the hands of a buyer than most buyers are qualified to repay. ARMs grease continued sales volume and higher prices when buyers lose their purchasing power due to increased FRM rates.

Excess funds mean more and larger properties can be sold at ever increasing prices and earnings, the **financial accelerator** event in action. But to build long-term stability into future real estate transactions, an issue of public confidence in the market, regulations need to control the types of mortgages

available to homebuyers and homeowners. It is precisely because ARMs appear so appealing to financially illiterate homebuyers that they need to be regulated to avoid harm to all involved.

The *minimum guidelines* existing for ARM-type mortgages need restructuring if the real estate market is to avoid future lender exploitation of buyers and owners. Most all buyers and owners are under-capitalized (read: dependent on employment income) and uneducated in the economics of ownership and finance. Worse, they have no sufficient time during a home purchase to become educated and gain experience sufficient to figure it out. Not so for lenders.

In the past, and even today, the appraisal system compels **appraisers** to collaborate in the real estate pricing scheme. Fundamentals dictate that the lesser value calculated based on comparable properties, cost of replacement or the actual or implicit rental income controls the ceiling price to be paid as the property's **fair market value (FMV)**. However, any buyer's agent will insist the price set in the purchase agreement is the property's true FMV.

Further, as appraisals have become more regulated through the intermediary *appraisal management companies (AMCs)*, it is not uncommon for an appraiser to disagree with the purchase price. This was especially true in 2014 due to the wild prices speculators and homebuyers paid in 2013 knowing the appraisal would certainly lower the price they paid on closing. [See Factor 12: Pricing]

Historically, brokers and their agents make judgment calls on the total mortgage amount a prospective home buyer is qualified to borrow. They simply quadruple (4x) the buyer's *gross annual income* to get an approximation of the mortgage amount. If the mortgage is conventional, the lender requires a 20% down payment.

Alternatively, they allowed the seller to carry 10% of the price in a second with a 10% down payment, called **80-10-10 financing** or **piggy back financing**.

Armed with this simple *mortgage-to-income* ratio formula, the agent knows a buyer making \$50,000 gross annually as a wage earner qualifies for a \$200,000 mortgage. At 80% value, the buyer needs \$50,000 in cash for a down payment on a home priced at \$250,000. At 6.6% interest, the payment would be 31% of the buyer's gross income, the figure Congress used in 2008 for monthly payments on a mortgage cramdown (*principal reduction*) for voluntary mortgage modifications under the *Home Affordable Modification Program (HAMP)*.

Congress has make it clear that those lenders whose mortgages the government backs may only make mortgages to individuals who will repay — a fair tradeoff by lenders for a government guarantee and low cost funds.

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.

Qualifying a buyer for a mortgage

80-10-10 financing

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.

Buyer counseling

Agents and brokers need to encourage all prospective buyer clients to apply for a written mortgage approval with *two or more lenders*, stating the specific maximum mortgage amount they will lend to the buyer. Further, harking back to better brokerage in times past, agents need to strongly consider employing the art of counseling. Counseling determines whether they want to work with a buyer by establishing the buyer’s capacity to pay for and retain ownership of a property. These issues need to be addressed before a discussion can begin about the property their buyer desires to purchase. [See **RPI Form 321**]

The buyer will need to have verifiable funds equal to the down payment to qualify for a mortgage. That is:

- 3.5% for financing insured by the Federal Housing Administration (FHA); or
- 20% for conventional financing, unless covered by private mortgage insurance (PMI).

Chapter 7.1 Summary

A real estate mortgage’s primary function is to provide additional capital for buyers and owners of real estate.

Mortgages made to finance real estate transactions are classified as either fixed rate mortgages (FRMs) or adjustable rate mortgages (ARMs).

FRMs provide stable, invariable long-term financing.

ARMs, on the other hand, do not have the characteristic elements of a real estate mortgage. ARMs are based on short-term rates designed for financing consumer products, such as cars, inventory, equipment, payroll and stock margins.

As appraisals have become more regulated through the intermediary appraisal management companies (AMCs), it is not uncommon for an appraiser to disagree with the purchase price.

Agents and brokers need to encourage all prospective buyer clients to apply for a written mortgage approval with two or more lenders, stating the specific maximum mortgage amount they will lend to the buyer.

Chapter 7.1 Key Terms

80-10-10 financing **pg. 111**
adjustable rate mortgage (ARM) **pg. 109**
fair market value **pg. 111**
installment sale **pg. 108**
leveraging **pg. 108**
return on investment **pg. 108**
speculator **pg. 110**

A lesson from the housing bubble

Chapter 7.2

After reading this chapter, you will be able to:

- understand how the secondary money market influences the housing market; and
- discern the way mortgage terms and conditions control the real estate market's environment.

securitization

tranches

teaser rates

Learning Objectives

Key Terms

Around April 2004, a dramatic 40% reduction occurred in the **capital adequacy ratio** of the nation's largest banks, a ratio which addresses a bank's level of solvency. This freeing up of their funds for investments led to a competitive frenzy among Wall Street banking institutions.

Securitization and subprime lending

The capital ratio reduction instantly drove them to snap up ownership in most all mortgage banking operations across the nation. As the nation's new-by-acquisition mortgage bankers, they were able to directly acquire ever-more high-yield, risky *adjustable rate mortgages (ARMs)* at ever greater profit margins without involving Fannie Mae or Freddie Mac as profit-taking intermediaries.

The ARMs they acquired were bundled into investment pools. These pools were then sliced into various levels of vertical-priority for investors to choose from to make investments, called **tranches**. These tranches within the mortgage pools were then fractionalized into millions of *mortgage-backed bonds (MBBs)*. The bonds created were then peddled by Wall Street bankers to other banking institutions and individual investors throughout the world. This process is called **securitization**.

tranches

Bonds issued by investment pools divided into various levels of risk, reward and rate of maturity.

Among the nation's five largest money handling institutions, *loan securitization* went on to increase by 32% after April 2004, according to data from First American Loan Performance. This increase was not mirrored by smaller American banking institutions.

securitization

The process of Wall Street bankers breaking up mortgage pools into mortgage-backed bonds and selling these bonds to various banks and individual investor.

Why the increase among large banks? By the time *demand* for mortgages peaked in mid-2005, Wall Street had perfected its vertically expanded system for originating, buying, bundling and reselling mortgages through the MBB market from home mortgage borrowers to millions of investors worldwide.

This drop in homebuyer demand for purchase-assist mortgages was the result of a dried up supply of financially able (and financially questionable) homebuyers.

Tantalized tenants

teaser rates

A temporary, introductory low interest rate found in some adjustable rate mortgages.

In order to satisfy Wall Street's demand for mortgages to securitize, tenants-by-nature had to be enticed to become homeowners. Also, property owners of all sorts had to be motivated to refinance. The answer to both difficulties came exclusively with their use, and exploitation, of ARMs.

ARMs provided low initial interest rates to qualify, called **teaser rates**, and very low payment schedule options for up to five years. Further, no verification of income was necessary to qualify for purchase by many pools.

This massive release of reserve funds for large banks demonstrates the ancillary (but fully expected) consequences of relaxing regulations on money handling institutions. These consequences American homeowners have now become well aware of.

Banking institutions broker U.S. dollars supplied exclusively by the Federal Reserve (the Fed) to sustain the nation's commerce. The dollar is a publicly trusted medium of exchange used by anyone that acquires it to avoid barter and related labor complications.

Until the 1980s, mortgage lending was subject to specific and fine-tuned rules. The rules were crafted after our last financial crisis to prevent risk-taking by bankers that jeopardize society and its institutions.

The government reins controlling money lending institutions established after our prior financial crisis of like magnitude (the *Great Depression* of the late 1930s) required the government to harness the animal spirits of Wall Street's *competitive advantage* ethos. Letting the reins of regulation go has produced devastating consequences throughout the world's economies — a financial crisis. The effects of the crisis are likely to be with us through the end of the decade.

No competitive advantage

Particularly hard hit were California homeowners. Californians are far removed from the inner-workings of the time-honored, apolitical money-printing system of central banks. In fact, economies the size of California usually require their own currency (medium of exchange) to keep themselves free of problems created outside of its borders (California) to avoid the fiscal austerity presently imposed when denominating pricing in the U.S. dollar (or worse, the Euro).

More intimate knowledge of the banking system by real estate brokers and homebuyers might have protected Californians from the risks advanced by private bankers in the build-up to the 2008 Great Recession.

It is better that private banking (money handling) institutions fall under government-regulated parameters allowing reasonable risk taking. Banks and hedge funds are depositories for the savings of individuals since they hold other peoples' money as deposits with the expectation they are safe and readily available on demand.

Any greater leeway given to banking institutions (commenced in 1982 with the introduction of ARMs and due-on deregulation), allows private bankers to pursue unreasonably risky or unjustified profits. Thus, banking institutions need to be regulated by limiting the range of their activity if as a society we are to keep risky money-making schemes well out of homebuyer reach.

Deregulation between 1982 and 2007 permitted and thus encouraged reckless lending while providing the expectations of a government bailout for overreaching. Evidence of this is the 2008-9 bailout, and the savings and loan bailout which occurred in the late 1980s (the result primarily of the 1982 Garn Act).

Bankers know the government will always bail them out and cover their losses when they over-extend themselves and their businesses begin to fail. This assurance has led to an American styled Capitalism of "privatized profits and socialized losses," a hybrid dance between government tax revenues and corporate operations.

It is the result of this risky overreaching, not profit making, which regulations are now again drawn up to correct. For real estate sales, re-regulation of lenders and mortgages will level out the cyclical swings in sales volume and foster long-term stability. The real estate industry needs to significantly reduce the feast or famine markets (boom and bust cycles) we have experienced, each with increasing detriment for the past 30 years.

**National
banking
regulation
is now
underway**

Chapter 7.2 Summary

In order to satisfy Wall Street’s demand for mortgages to securitize, tenants-by-nature had to be enticed to become homeowners. Also, property owners of all sorts had to be motivated to refinance. The answer to both difficulties came exclusively with their use, and exploitation, of ARMs.

More intimate knowledge of the banking system by real estate brokers and homebuyers might have protected Californians from the risks advanced by private bankers in the build-up to the 2008 Great Recession.

Chapter 7.2 Key Terms

securitization	pg. 113
teaser rates	pg. 114
tranches	pg. 113

Preventing the next real estate bubble

Chapter 7.3

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.

Consumer Financial Protection Bureau (CFPB)

Dodd-Frank Wall Street Reform and Consumer Protection Act

mortgage-backed bond (MBB) qualified residential mortgage (QRM)

Learning Objectives

Key Terms

The Federal Reserve (the Fed) uses **monetary policy** to preemptively quash consumer inflation booms. [See Factor 17: 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.

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

Harness market momentum excitement

Easy money

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 of stimulative reactions, see the Fed's handling of the dot-com bust, the tragedy of September 11, 2001 and the 2020 COVID-19 pandemic.

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.

mortgage-backed bond (MBS)
An asset-backed security representing a claim on the cash flows received on a mortgage.

Wall Street wunderkinds making money on volatile **mortgage-backed bonds (MBSs)** weren't going to blow the whistle either. Rating agencies fully collaborated, adding a final layer to the Ponzi system, upgrading the junk MBSs into AAA investment portfolios. These investment portfolios were then made available for worldwide consumption.

Golden policies, but not emboldened

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 MBS market.

The Fed now batting clean-up

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.

The progress made in the 2010's to regain jobs was 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, from 2008 to 2019, California's working-age population increased by 1.8 million. Thus, it wasn't until late-2019 that California finally caught up to pre-2008 recession job levels when counting population growth. Of course, this was just in time for the 2020 recession to hit a few months later, which resulted in job losses of historic proportions.

Labor force participation (LFP) remained low throughout the recovery and continues to drop in 2021. During the last decade, this low LFP rate was due to the failure to create the jobs needed to compensate for California's population growth since the 2007 jobs peak. However, the pandemic forced many would-be laborers out of the workforce, some into early retirement and others into caring for young or elderly relatives. Thus, **Realty Publications, Inc.** anticipates the state will likely hit the target for a full jobs recovery around 2024. [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?¹

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.

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 8: 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.

Lean or clean?

A decade of forced debt reduction

¹ William R. White, *Should Monetary Policy 'Lean or Clean'?*

Bringing the message home

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.

Limit the amount of credit available

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 difficulty of change: short-term benefits lost

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.²

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;
- 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.

Dodd-Frank

Dodd-Frank Wall Street Reform and Consumer Protection Act

A federal consumer protection law which created minimum standards and oversight for consumer mortgage origination.

Consumer Financial Protection Bureau (CFPB)

An independent federal agency fathered by the Dodd-Frank Act responsible for regulating consumer protection with regards to financial services and products.

qualified residential mortgage (QRM)

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%.

² 15 United States Code §§1601 et seq.; 12 CFR

This removes the financial incentive for MLOs to originate mortgages homebuyers can't afford to repay.

The qualified residential mortgage (QRM)

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 and amended as of June 31, 2021. 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
- meet a pricing threshold, when the loan's annual percentage rate (APR) is within a certain range of percentage points of the average prime offer rate (APOR), dependent on the type and amount of mortgage.³

Prior to the June 31, 2021 expiration date of the GSE (which stands for Government Sponsored Entities, referring to Fannie Mae and Freddie Mac) Patch, to qualify as a QM, the back-end **debt-to-income (DTI)** ratio was not to exceed 43%. However, the Consumer Financial Protection Bureau (CFPB) proposed replacing the 43% DTI measure with the new pricing threshold, as this threshold reflects both the lender's interests and fees.

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.

QRM needs more teeth

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.

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,

³ 12 Code of Federal Regulations 1026.43(e)(2)

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.

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.

Credit report oversight

The purpose of these changes is to protect mortgage borrowers, not mortgage and transaction providers.

Chapter 7.3 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:

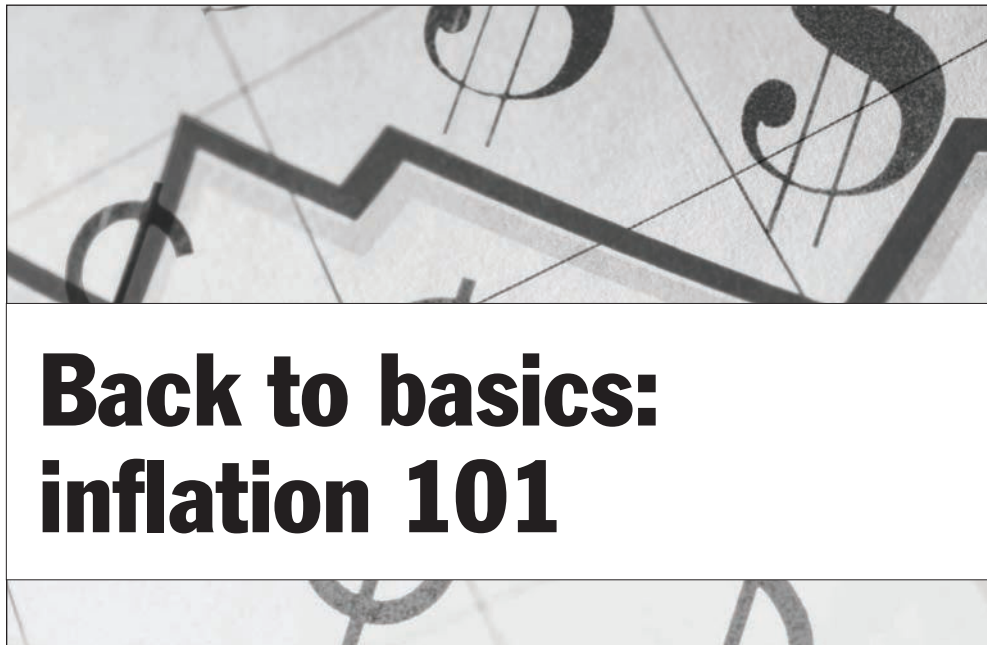
- minimum standards for consumer mortgages;
- integrated consumer mortgage disclosures;
- loan originator compensation rules; and
- more stringent servicing rules.

Additionally, the Consumer Financial Protection Bureau (CFPB) has begun supervising large credit reporting companies.

Chapter 7.3 Key Terms

Consumer Financial Protection Bureau (CFPB)..... pg. 121
Dodd-Frank Wall Street Reform and Consumer Protection Act pg. 121
mortgage-backed bond (MBB) pg. 118
qualified residential mortgage (QRM)..... pg. 121

Factor 8: Inflation & CPI



Back to basics: inflation 101

Chapter 8.1

After reading this chapter, you will be able to:

- understand the fundamental economic concepts of consumer price inflation versus asset price inflation; and
- determine how both consumer price inflation and asset price inflation relate to real estate.

Consumer Price Index (CPI)

consumer price inflation

disequilibrium

fiat money

monetarist economic view

quantitative easing

Learning Objectives

Key Terms

Inflation is a word that is often bandied about freely, meaning different things to different actors in the economy. At times, the concept is considered mystical and used with a lack of confidence in understanding.

**Fluctuation
in the price
level of goods
and services**

At its core, *inflation* is a basic fundamental of macroeconomics, even while it has a profound and complex effect on California's economy which real estate licensees have a serious reason to understand so they can advise clients in real estate transactions.

There are two basic types of inflation:

- **consumer price inflation;** and
- **asset price inflation.**

Although the two are intertwined with the dollar (and California real estate is a *dollar denominated asset*), distinctions need to be drawn between the two concepts.

Consumer price inflation is an increase in the general price level of all goods and services in the economy. Simply, the rate of consumer price inflation is set by the rise in price of everything we buy to consume.

While this includes *rent movement* in housing, it does not include the price movement of the underlying asset, the home itself. Home improvements are not consumed, just used (though improvements do deteriorate, called depreciation for tax purposes). Improvements are related to savings – the store of wealth in a home – and are not associated with day-to-day goods or services.

The *general price level* is the average price of all goods and services sold in the economy calculated over a given period of time. The time period can be any interval, from one day to one year. Most changes are reported as the rate of inflation that has taken place over the past 12-month period.

Changes in the general price level are measured and indexed as a figure by the *Bureau of Labor Statistics*. This figure is reported as the **Consumer Price Index (CPI)**. The CPI measures and tracks the rate of consumer inflation. CPI is simply an index of fluctuations in the general price of a huge selection of consumable products — goods and services. [See Figure 1]

In an economy of **fiat money** such as ours, currency:

- is controlled by a central bank;
- is backed by the full faith and credit of the national government; and
- has no direct tie to an underlying commodity, such as gold, or pegged to another currency.

Inflation is fundamentally a result in an increase of the *fiat money* supply beyond the level of additional production of goods and services. As with all rules, exceptional conditions alter application of this rule on inflation.

For example, when interest rates in a recession are essentially at zero and government spending shrinks and corporate borrowing is minimal, the rule does not apply since no one is crowding out anyone else due to the very low

consumer price inflation

An increase in the general price level of all goods and services consumed in the economy.

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.

Where does inflation come from and why do we care?

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.

The basket of CPI goods and services	
<input checked="" type="checkbox"/>	FOOD AND BEVERAGES (breakfast cereal, milk, coffee, chicken, wine, full service meals and snacks);
<input checked="" type="checkbox"/>	HOUSING (rent of primary residence, owners' equivalent rent, fuel oil, bedroom furniture);
<input checked="" type="checkbox"/>	APPAREL (men's shirts and sweaters, women's dresses, jewelry);
<input checked="" type="checkbox"/>	TRANSPORTATION (new vehicles, airline fares, gasoline, motor vehicle insurance);
<input checked="" type="checkbox"/>	MEDICAL CARE (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services);
<input checked="" type="checkbox"/>	RECREATION (televisions, cable television, pets and pet products, sports equipment, admissions);
<input checked="" type="checkbox"/>	EDUCATION AND COMMUNICATION (college tuition, postage, telephone services, computer software and accessories);
<input checked="" type="checkbox"/>	OTHER GOODS AND SERVICES (tobacco and smoking products, haircuts and other personal services, funeral expenses).
*Courtesy of the Bureau of Labor Statistics	

Figure 1

The basket of CPI goods and services

demand by all borrowers, public and private, for money. These zero lower-bound interest rate rules were relearned in the long recovery from the 2008 recession and reintroduced more recently during the **2020 recession**.

The Federal Reserve (the Fed) dictates the money supply, which includes the amount of cash money printed by the U.S. Treasury and delivered exclusively to the Fed. The Fed also places money in circulation – prints it – in the form of credit extended to banks and purchases of bonds. [See Factor 17: Monetary policy]

monetarist economic view

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.

*Editor's note — There are competing views on the causes of consumer price inflation. For the purposes of the discussion in this chapter, we refer to a basic understanding of inflation known as the **monetarist view**. A further discussion of the expanded **Keynesian view** of inflation, which incorporates issues of supply and demand among other factors, is discussed in Chapter 8.2.*

From the *monetarists view*, if the supply and demand for goods and services remain at a constant, and there are no issues of scarcity or abundance of products, an increase in the amount of money in circulation will result in inflation. Note that this definition of the cause of inflation is not necessarily due to an increased demand for or a lack of supply of goods. However, constants do not exist in most recessionary environments, limiting the application of the rule.

In application of this rule, an increase in the amount of money in circulation results in each dollar a consumer spends being limited in its ability to the purchase of a smaller percentage of whatever good or service they are after. This is also often thought of as *too many dollars chasing the same amount of goods and services*. Real estate syndicators gathering money from others for the purchase of yet-to-be-located real estate too often get caught in this pricing cycle as they pursue property to keep their flow of funds vested.

In essence, as the general price level of products increases due to an excess in the money supply, the consumer's **purchasing power** decreases. This results in a dollar that is worth less today than it was the day or the year before. However, again, recessions find any excessive money supply sitting in the vaults of the bankers, not flowing freely in the marketplace as borrowed capital until a recovery is underway.

The Federal Reserve's role

The Fed plays a very important role in controlling inflation in the U.S. economy, one of its two mandates. In this economy of fiat money, the Fed has controlled the money supply as a matter of our *national monetary policy* for the past 100 years.

Keep in mind that for inflation to occur when excess money is in the banking system, dollars have to be in **circulation** by way of mortgages or other lending, not stored in reserve by bankers rendering the dollars unavailable for consumer spending. As of August 2020, 2.8 trillion dollars are in reserve by commercial banks on deposit at the Fed (the Fed pays 0.5% annual interest on deposits).

In essence, the Fed controls inflation by controlling the amount of *money in circulation*, not the amount of money held by bankers. It has several tools at its disposal to do this.

When the rate of inflation rises above its target level, the Fed takes the excess money out of circulation by raising:

- the *reserve requirements* on private banks for deposits with the Fed, thereby leaving private banks with less money to lend; and
- the interest rate the Fed charges private banks when they borrow funds from the Fed, which the Fed alone is authorized to “print.”

This also works the other way around. In the event of disinflation, a decline in the rate of inflation below the 2% target, or *deflation* (below zero inflation), the Fed lowers reserve requirements on private banks and decreases interest rates paid by the private banks on funds borrowed from the Fed (and others). This is done to increase the amount of money in circulation.

As a last resort, the Fed may also buy government bonds and mortgage backed bonds held by private banks and others. As a result, the Fed directly injects fresh cash into circulation, a money-pumping process semantically known as **quantitative easing** or **QE**.

All of this monetary policy adds up to the Fed fulfilling their mandate to maintain economic growth through:

- *stable consumer prices*; and
- *stable employment*. [See Factor 17: Monetary policy]

You will notice neither of these monetarist tools take into account an extreme imbalance in supply and demand, called **disequilibrium**.

For instance, during times of war or scarcity in a particular commodity such as oil, these macroeconomic monetary interventions available to the Fed are essentially impotent. Thus, these one-off shocks are left to work their way through the economy, which they do, until they no longer drive prices up or down for the reason the shock pricing has stabilized and no longer dropping or rising — the point at which the market is said to “correct” itself.

The Fed’s arsenal

quantitative easing (QE)

The purchase of government or mortgage backed bonds by the Federal Reserve to drive down interest rates and increase liquidity.

disequilibrium

An extreme imbalance in supply and demand which prevents the market from reaching equilibrium in pricing.

Chapter 8.1 Summary

There are two basic types of inflation, consumer price inflation and asset price inflation. Although the two are intertwined with the dollar (and California real estate is a dollar denominated asset), distinctions need to be drawn between the two concepts.

Consumer price inflation is an increase in the general price level of all goods and services in the economy. Simply, the rate of consumer price inflation is set by the rise in price of everything we buy to consume.

The Fed plays a very important role in controlling inflation in the U.S. economy, one of its two mandates. In this economy of fiat money, the Fed has controlled the money supply as a matter of our national monetary policy for the past 100 years.

Chapter 8.1 Key Terms

Consumer Price Index (CPI)	pg. 126
consumer price inflation	pg. 126
disequilibrium	pg. 129
fiat money	pg. 126
monetarist economic view	pg. 128
quantitative easing (QE)	pg. 129

Beyond the basics: asset price inflation in the real estate market

Chapter 8.2

After reading this chapter, you will be able to:

- distinguish asset price inflation in the real estate market from consumer price inflation; and
- analyze and interpret the prevailing myths regarding real estate prices.

asset price inflation

commodity

financial accelerator

going negative

liquidity trap

zero lower bound interest rate

Learning Objectives

Key Terms

Consider **asset inflation** in terms of various economic factors affecting the pricing in asset markets, such as stocks, bonds and real estate. The primary asset that concerns us in this material is real estate.

In contrast to the items priced to determine *consumer inflation*, real estate is not a **product** (i.e., a good or a service). It is an asset. The simple distinction here can be thought of in terms of consumption: a product (**commodity**) is, generally speaking, a consumable good requiring constant replacement. In contrast, an asset is reuseable, over and over again during a long term, subject to physical deterioration and obsolescence.

Once a *commodity* such as oil is purchased, it is consumed and needs to be replaced by further production of the commodity.

Alternatively, a tangible or intangible asset is considered property. This property is held by an owner who may expect future economic opportunities during ownership, i.e., by using it themselves, leasing it to others, selling or trading it. The owner does not consume or deplete it. It does not therefore need to be replaced when used, as is the case with commodities.

The *Consumer Price Index (CPI)* does not measure *asset inflation*. Asset prices behave quite differently and independently from consumer price movement.

Asset inflation: where does real estate fit in?

asset price inflation

A rise in the price of assets, such as stocks, bonds and real estate.

commodity

A marketable good or service.

The amount of money in circulation controls

Although inflation behaves differently between assets and consumer goods, the two are intimately related. Why? They are both directly affected by the amount of money in circulation. At times, one is more susceptible to this influence than the other. In 2019, asset inflation has turned negative in the form of declining home prices, while consumer inflation is barely rising.

If the money supply in circulation increases to the point it causes consumer price inflation, the purchasing power of the dollar has decreased. In tandem, the level of real incomes decreases. As income loses purchasing power, workers are provoked to demand wage increases to at least keep up with inflation, if they are to continue their present style of living.

Consider consumer inflation in terms of increases in rent, amounts paid for leasing the use of a home or commercial space; a consumable event and an income and expense sheet expenditure item. The right to possession granted to a tenant by leasing is not an asset, and thus it is not a balance sheet item for the tenant. On the other hand, ownership of a home or commercial property is a *dollar-denominated asset* bought and sold, and listed on the owner's balance sheet.

At a fundamental level, asset price inflation is directly affected by the money supply. However, one needs to take it further to get a deeper understanding of this interplay. One needs to consider the idea of **supply** and **demand** to fully understand asset price inflation in the real estate market.

Consumer price inflation versus asset price inflation

Perhaps the most important factor affecting real estate price inflation is the relationship between *supply* (marketable inventory on the multiple listing service (MLS)) and *demand* (ready buyers) in the real estate market.

As user-demand for real estate ownership outpaces the MLS supply of property for sale, the market environment experiences a *scarcity* of supply reflected in reduced inventory for sale. As a result, real estate prices increase (or *inflate*). This pricing occurs whether or not there is an excess in the supply of money, but the excess supply will accelerate the rate of asset inflation until of course the excess supply is removed by an increase in interest rates.

Just as with consumer price inflation, the *purchasing power* of the real estate (asset) buyer diminishes since there are too many dollars being allocated to chasing a fixed quantity of assets (property). Thus, the buyer's dollar will

Figure 2

Consumer price inflation versus asset price inflation

Consumer price inflation (CPI) is best understood as a fluctuation in the available money supply (the basic monetarist view).

Asset inflation necessarily includes issues of supply and demand as well as interest rates, especially in terms of its relationship to rates on mortgages taken out to purchase property.

now purchase a smaller percentage of the same home as it would have in the period prior to home price inflation. Thus, more dollars are required to buy the same property than needed at an earlier date.

Editor's note — Buyer purchasing power is also determined by interest rates and buyer incomes. For a discussion on this and the Buyer Purchasing Power Index, see Chapter 2.5.

A word of caution: real estate price inflation is often confused with real estate *asset appreciation* for lack of awareness of their obvious distinctions. They are mutually exclusive principals, but both relate to an increase in property value over the price paid for the property. When discussing real estate prices affected by *monetary policy*, one is referring solely to the portion of price increases resulting from asset inflation, as we are doing here. [See Figure 2]

Real estate appreciation is just what it is called: an increase in price driven by the personal appreciation that buyers and sellers have for a particular parcel of real estate. Property price appreciation is primarily driven by an increase in population density around the location of the property and the income of that population — not the intrinsic value of a parcel of real estate or by consumer price inflation figures.

In math terms, the price attributable to appreciation is the increase in value of a property exceeding the rate of inflation brought on by annual lost purchasing power of the dollar — consumer inflation, precisely.

Thus, “appreciation” is a qualitative term that reflects the human perception of a property’s value. This perception is then reflected in pricing when this perception increases demand for the location, or simply for the specific property, beyond the price dictated by the rate of consumer inflation.

The prevailing lesson taught by the implosion of the Millennium Bubble is that price and value are not well correlated. Most of all, the recurring notion that real estate perpetually “appreciates” was destroyed by the Great Recession, or at least for a generation or so. These cardinal myths floating in the real estate market need to be banished from the realm of rational discussions concerning real estate price increases.

Mean pricing ideas are also here involved as properly instructive of the future. The **mean price trendline** of real estate reflects the consumer inflation rate and income levels (and general population increases) and a further increase in value brought on by the location’s appreciation. Thus, real estate pricing over the full term of a business cycle, not periodic or permanent property value increases, include the rate of consumer inflation and the rate of any increased appreciation due to changing demographics of the location. [See Factor 12: Pricing]

Real estate price inflation versus appreciation

Interest rates and real estate price inflation

Although supply and demand in the real estate market are affected by a multitude of factors, the demand for real estate as we have known it since the Great Depression is fundamentally encouraged by the availability of mortgage funds from lenders. In a word, real estate acquisitions are *leveraged* in over 80% of transactions since very few buyers-occupants have cash savings sufficient to pay more than a small fraction of the seller's asking price. [See Factor 2: Interest rates]

As most real estate acquired to be held for the long term is not purchased with cash, the primary source for satisfying property demand comes from lender purchase-assist financing. The availability and abundance of purchase-assist financing is dictated by interest rates, influenced by the general creditworthiness of the borrower and the appraised value of the collateral.

Lenders hold hostage the real estate market's primary means for facilitating the purchase of property. Thus, they are mostly in control of real estate (asset) price inflation. However, lenders outsource and rely exclusively on appraisers and credit agencies for two critical decisions:

- one concerning the qualification of the property; and
- the other the borrower's propensity to repay debt.

During the 2000s, this reliance proved defective, and will likely return to haunt lenders during the next real estate boom as regulation has done little to correct either.

However, this is only part of the picture. The Federal Reserve (the Fed) plays an important role here as well by setting interest rates.

The financial accelerator effect

financial accelerator

The cyclical phenomenon of increasingly larger mortgage amounts based on increasingly inflated prices of the same collateral.

It was the Fed's failure to control interest rates during the 2000s that produced the **financial accelerator effect** which led to the crash of both real estate prices and Wall Street markets. The *financial accelerator effect* occurs once mortgage lenders begin realizing greater profits due to asset price inflation in the real estate market.

As prices went up, lenders earned greater returns on their capital regardless of the interest rate. They were able to periodically lend ever greater principal amounts on new mortgages as prices increased — all based on the same property as collateral.

Further, each lender wanted greater profits as a matter of maintaining their competitive advantage since they had to attract depositors by paying ever greater returns lest they lose them to other lenders. Emboldened by the notion that the collateral they were holding was "worth" more than the mortgage amount (a money illusion), lenders made more and larger mortgages to ever less qualified borrowers collateralized by the same or comparable property. The result was massively increased homeownership among those who were tenants not qualified to be homeowners.

This was the prelude to the vicious market cycle the Fed was supposed to regulate out of existence but failed to do. Congressional de-regulation since

1980 set the Fed up for failure during the decade of 2000, and the Fed fell into the trap by constantly lowering interest rates to improve economic conditions, called the **Greenspan Put** at the time. The result was the financial crisis of 2007 when interest rates hit the zero lower-bound rate when a negative rate was then needed to help the economy when fiscal policy was unwilling to invest in sufficient projects to keep the population employed.

Consider the landscape of the real estate market in 2021. Prices are commonly perceived to be high by end users of real estate, having increased rapidly during 2020. However, this price increase is due solely to the equal increase in purchasing power — lower interest rates — despite halting home sales volume alongside historic job losses. [See Factor 12: Pricing]

In order to create some stability for the real estate market and stimulate mortgage lending to end users acquiring real estate, the Fed is exercising its right to keep short-term interest rates at essentially zero without **going negative** as part of their monetary policy. The Fed initially increased short-term interest rates in December 2015, though FRM rates did not rise until late-2016 when bond rates eventually rose. Then, FRM rates resumed their rise in late-2017, increasing through 2018, falling back beginning in 2019.

The Fed's hope was that low nominal interest rates may generally encourage lenders to make more loans at cheaper rates to homebuyers (and businesses). More lending for more commerce and real estate sales is preferable to bank's holding massive amounts of reserves un-lent, which is much the case today.

So the thinking goes: flush the banks with cheap cash so they will then redistribute the cash via purchase-assist financing to homebuyers. This will make willing those ready and able homebuyers by passing on low interest rate to them – lending at a rate equal to the rate for risk-free 10-Year Treasuries and the historical 1.5% profit margin.

Has the Fed's plan worked? Indeed, homeowners have taken advantage of low interest rates by **refinancing** at record levels, which has boosted lender profits during the lean sales of mid-2020. Further, historically low interest rates have allowed homebuyers to pay more for their home purchase, to the benefit of sellers. However, low interest rates alone cannot sustain a housing market. They also present another problem, which is that, once rates are at zero, what then?

This dynamic can be summed-up with two financial crisis concepts:

- **zero lower bound interest rates;** and
- **the liquidity trap.**

The scenario described above regarding the current plan for asset inflation is one piece of the *zero lower bound interest rate* puzzle. As lowering the interest rate is the Fed's primary means for stimulating lending and thus home sales, there needs to be an interest rate baseline which is deemed effective to stir up buyer demand. [See Factor 17: Monetary policy]

The market today

going negative

The Federal Reserve's charging of interest on the excess reserves of lenders, stimulating lending activity.

zero lower bound interest rates

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.

The zero lower bound and liquidity trap

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.

The aftermath of zero-bounded rates

Consumer inflation is the name of this game (for now)

However, once rates have reached zero, the Fed is rendered impotent to move the economy, since it is unwilling to lower the rate sufficient to excite lenders and borrowers by the Fed going negative on interest rates. It may not (politically in the U.S.) lower rates beyond the zero lower bound as is needed to spark bankers and buyers of homes into action. (Europe's banks have overcome this mental barrier and gone negative to encourage borrowing and spending.)

By the Fed going negative on their lending rates (to banks, not the public or homebuyers), the Fed would literally be paying banks to accept cash advances from the Fed. Remember, the Fed has an infinite supply of money, is always repaid, and can never become insolvent.

In the aftermath of zero-bounded rates, inflation is still below the Fed's target rate of 2% and no expectation in the long-term bond market that it will rise for a decade or so, the mortgage lending market remains inherently sluggish — the *liquidity trap*. The likely reason is the lack of sufficient consumer inflation to encourage spending. Banks are swimming in basically free cash facilitated by the Fed. They are in a state of extreme liquidity since they have tons of cash that they have deposited with the Fed and are not investing in banker's assets, such as mortgages.

Yet, credit — cash — is available, but only to the most qualified buyers. Even as interest rates have become more attractive to potential homebuyers and refinancers, mortgage credit availability has declined.

This is the liquidity trap Californians are snared by. While cheap cash is in the bank's coffers, it remains trapped out of reach of many prospective buyers.

This brings us back full circle to consumer price inflation and the *CPI*.

Until banks open the floodgates of liquidity, sustainable asset price inflation in the real estate market will only be a reality once the economy as a whole — jobs and wages — picks up.

When the economy reaches this point of recovery, it will mean:

- a return to full employment, or the December 2019 jobs peak;
- increasing gross domestic product (GDP) exceeding the rate of inflation and California's 1% annual population growth; and
- a complete flush of the building foreclosures from the market.

Only then will real estate be ready to enter the next virtuous market cycle. Once the ball of the California economy starts rolling again, the market will be released from the liquidity trap and those zero bound rates may start working.

The next time we escape the Fed's zero rates it will herald in a future of continually rising interest rates with a time horizon of two or three decades, except for dips during recessionary periods.

Mortgages rates are expected to remain near their present low levels in 2021-2022, reversing course once a consistent recovery is underway, beginning around 2023 and the years following.

Looking forward through 2021 and 2022, expect real estate prices to fall back, closer to the mean price trendline, which anchors prices to the annual rate of consumer inflation, plus a small amount for appreciation due to population build up and wage increases. Any annual rise actually experienced in market prices beyond 3% is unsustainable since average homebuyer incomes often increase at near the same rate.

Five to seven years of ownership on future acquisitions will give an owner the ability to sell and recover their cash down payment and principal amortization as net sales proceeds. Those lucky to live in a location which experiences excessive population and income growth will take profits due to regional appreciation.

Thus, right now California real estate, regardless of type, is essentially a hedge against consumer inflation for those in ownership.

**Hedge
against
inflation**

Chapter 8.2 Summary

In contrast to the items priced to determine consumer inflation, real estate is not a product (i.e., a good or a service). It is an asset. The simple distinction here can be thought of in terms of consumption: a product (commodity) is, generally speaking, a consumable good requiring constant replacement. In contrast, an asset is reuseable, over and over again during a long term, subject to physical deterioration and obsolescence.

The mean price trendline of real estate reflects the consumer inflation rate and income levels (and general population increases) and a further increase in value brought on by the location’s appreciation. Thus, real estate pricing over the full term of a business cycle, not periodic or permanent property value increases, include the rate of consumer inflation and the rate of any increased appreciation due to changing demographics of the location.

It was the Fed’s failure to control interest rates during the 2000s that produced the financial accelerator effect which led to the crash of both real estate prices and Wall Street markets. The financial accelerator effect occurs once mortgage lenders begin realizing greater profits due to asset price inflation in the real estate market.

In the aftermath of zero-bounded rates, inflation is still below the Fed’s target rate of 2% and no expectation in the long-term bond market that it will rise for a decade or so, the mortgage lending market remains inherently sluggish — the liquidity trap. The likely reason is the lack of sufficient consumer inflation to encourage spending. Banks are swimming in basically free cash facilitated by the Fed. They are in a state of extreme liquidity since they have tons of cash that they have deposited with the Fed and are not investing in banker’s assets, such as mortgages.

Chapter 8.2 Key Terms

asset price inflation pg. 131
commodity pg. 131
financial accelerator pg. 134
going negative..... pg. 135
liquidity trap pg. 136
zero lower bound interest rates pg. 135

Factor 9: Savings



The 20% solution: personal savings and homeownership

Chapter 9.1

After reading this chapter, you will be able to:

- identify new and proposed rules for mortgages; and
- understand the relationship between the current rate of personal savings and mortgage down payment requirements.

qualified mortgage (QM)

skin in the game

qualified residential mortgage (QRM)

Learning Objectives

Key Terms

Mortgage regulators have cracked down on wayward purchase-assist lenders who reigned in the 2000s. Two rules which took effect in 2015 affect consumer mortgage lending:

- **qualified residential mortgages (QRMs)**, which focus on lender risk retention under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank); and
- **qualified mortgages (QMs)**, which focus on underwriting standards and provide a safe harbor option for lenders to automatically comply with ability-to-repay rules under the Truth in Lending Act (TILA).

Mortgages: QRM versus QM

qualified mortgage (QM)

A consumer mortgage which meets ability-to-repay rules under the Truth in Lending Act.

QMs, as defined by the **Consumer Financial Protection Bureau (CFPB)**:

- prohibit consumer mortgages approved with no or minimal buyer documentation (no/low doc mortgages);
- prohibit deceptively low teaser rates; and
- submit consumer mortgages to rigorous underwriting standards.

Previously, QMs limited homebuyer's total back-end debt-to-income (DTI) ratio to 43%. Beginning July 1, 2021, mandatory compliance of the new general QM requirements will go into effect. The new **general QM** replaces the old DTI requirement with a price-based rule, measured by comparing a loan's **annual percentage rate (APR)** to the average **prime offer rate (APOR)**.

Further, as of March 1, 2021, a new type of QM called a **seasoned QM** exists. Under this category, the originating creditor or first mortgage purchaser holds the mortgage in their portfolio for 36-months before the mortgaged is "seasoned" into an acceptable QM. During this seasoning period, the mortgage loan may have no more than two 30+ day delinquencies and no 60+ delinquencies at the end of the seasoning period.

To be classified as a *QRM*, a consumer 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 mortgage, 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;
- a total back-end debt-to-income (DTI) ratio that does not exceed 43%.¹

The QRM was anticipated to bring about a mandatory 20% down payment for consumer mortgages with the most favorable terms. However, the 20% down payment requirement was lost in the published QRM definition.

For "skin in the game," lenders that originate consumer mortgages which do not follow the QRM rules must retain at least 5% of the non-qualified mortgages they sell on the secondary mortgage market (a process called **securitization**).

The 20% down payment, once the standard for consumer mortgages, became a quaint novelty during the fevered years of the Millennium Boom.

qualified residential mortgage (QRM)

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%.

The 20% down payment standard

¹ 12 Code of Federal Regulations 1026.43(e)(2)

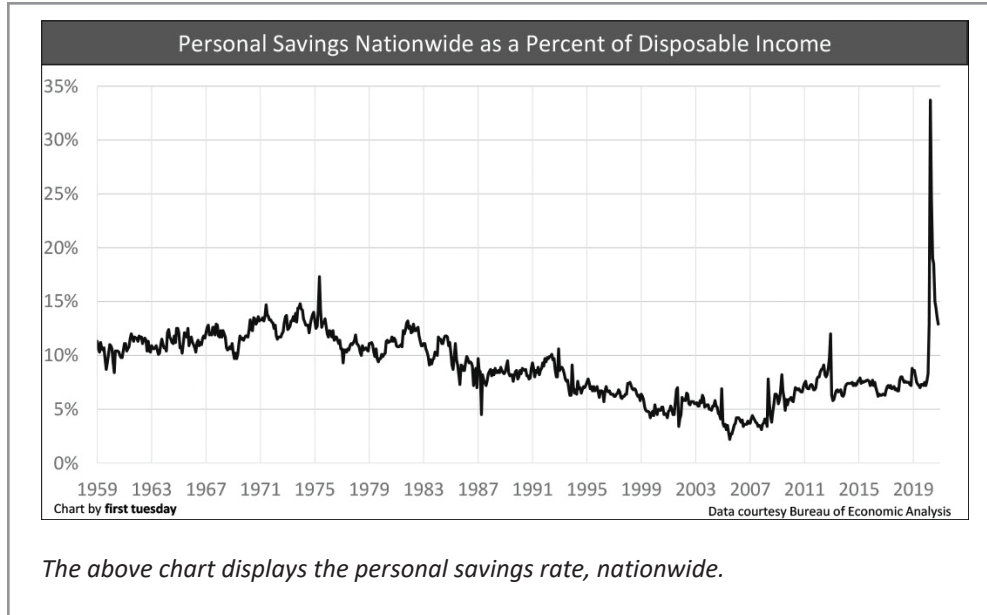


Figure 1

Personal Savings Nationwide as a Percentage of Disposable Income

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Homebuyers (and lenders) got used to the easy days of purchasing a home with 3.5% down, 0% down or even 0% down plus seller-paid or financed closing costs.

The disparity between the huge financial burden of owning a home and the small barrier set by the homebuyer's nonexistent initial investment was patently disproportionate, but seductively convenient. "No savings necessary!" became the message delivered to those interested in future homeownership, at least during the 2000 decade.

Personal savings as a percentage of disposable income hit a 50-year low during the Millennium Boom, as reported by the federal Bureau of Economic Analysis (BEA). In the years that followed, the savings rate gradually climbed until spiking to 34% in April 2020, coinciding with the arrival of the first round of stimulus checks, which many put directly into savings. [See Figure 1]

Over the last few decades, savings has followed a path conversely proportionate to consumer confidence. When consumer confidence is running high, the rate of personal savings falls. When confidence is relatively low — as during the 2020 trifecta of recession, financial crash and pandemic — personal savings rises. A financial "comfort zone" is accommodated either way.

Here in California, the room for saving is even narrower due to the high cost of living, thus the savings rate is usually lower than the national average. Over the past decade, while jobs recovered steadily from the 2008 recession, home prices and rents increased far faster than incomes. This disparity has chipped away at the **ability** to accumulate savings sufficient to cover emergencies, let alone enough for a down payment on a home. Further, the **incentive** for saving remains as low as the "negative" interest rates on savings accounts,

which are insufficient to cover inflation increases. In turn, the savings rate remains low in California, meaning 20% down payments are increasingly rare among first-time homebuyers.

Looking ahead to 2021 and beyond, many residents will find themselves drawing on savings to survive as the damaged economy continues to struggle through this recession and pandemic. Expect to see the savings rate jump again when the next round of stimulus checks arrive, and remain well above normal for the next couple of years as individuals who remain employed turn to saving as a way to fend off recessionary anxiety.

Increased personal savings during recessions

The personal saving rate tends to rise during recessionary periods. However, the increased savings during the Great Recession can also be attributed on a smaller scale to those who strategically defaulted on their home mortgage, were foreclosed on or sold on a short sale. These prior owners now simply had more money at the end of the month, and better understood the vicissitudes of fortune (read: a home can lose value just like any other asset). No longer chained to their negative equity asset, following the loss of homeownership, they were able to retain the money they would have wasted paying on a dead-end mortgage to put towards their new home, education and family emergencies.

Likewise, during the 2020 recession savings jumped both due to rapidly decreased consumer confidence but also due to the interference of individual stimulus checks. Those who were able to retain their jobs had the ability to put those checks directly into savings to ease their recession and pandemic anxieties.

The quarterly chart from 2005 to present displays a mostly flat trend in savings from 2013 through 2019, the result of the elongated recovery from the 2008 recession. Households are limited in their saving efforts, as rents escalate and average wages for the vast majority of households remain stunted not having kept up with their loss of purchasing power due primarily to price inflation and a large available labor pool. [See Figure 2]

The savings which many accumulated during 2020 and again in 2021 with the second and third round of stimulus checks will gradually become depleted as the fallout from the 2020 recession continues to be extended. Expect this bumpy trajectory to continue as we navigate the remainder of this rocky recovery.

Personal savings rate runs contrary to the economy

When the economy is doing well — or perceived to be doing well — people are less likely to tuck away money for the proverbial rainy day. Government revenue management suffers from the same delusion. The same flawed logic which soothed people (and property tax reliant local governments) into believing property values will appreciate ever higher told them the economy will always be rosy enough to support their rampant spending beyond their personal incomes.

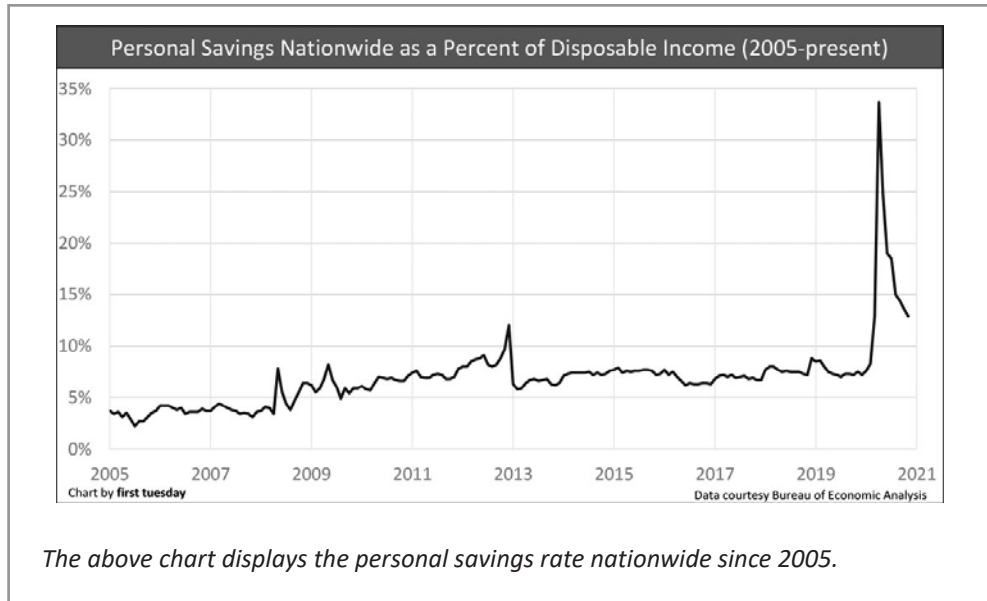


Figure 2

Personal Savings Nationwide as a Percentage of Disposable Income (2005-present)

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This idea was buttressed by the abundant home financing made available to practically everyone by lenders. The financial gurus of Wall Street and the Department of Housing and Urban Development (HUD) at the turn of the century decided it is a good idea to allow people to make the biggest purchase of their lives funded by borrowings with no personal financial stake in their property.

It was previously said that people will always pay the mortgage on the home the own and occupy. However, that was the observation when homebuyers had **skin in the game** with a 20% down payment.

The dip in the rate of personal savings also reflected the attitude that the house, once purchased, may be used as a bottomless ATM machine.

Who needed savings when a home was purchased for nothing, and taking out a *home equity line of credit (HELOC)* was a surefire way of getting quick cash whenever needed? Never mind the long-term repercussions of these financial practices. Much like the boom-time economy, it was taken for granted that real estate will appreciate ad infinitum. Equity buildup in their home was all the savings one needed. Even Wall Street investors and their rating agencies fell for it.

Homeowners and mortgage holders were rudely awakened by the onset of the 2008 recession and financial crisis produced by the real estate crash. With the addition of the following extenuated job recovery into 2014, homeowners and those looking to become homeowners in the near future began to realize that personal savings are a necessity.

Once this concept becomes an expectation, everyone who aspires toward homeownership will save money. In but a few years, the habit will become ingrained and single family residence (SFR) sales volume will return to normal levels as though the history of no down payment is just that: history.

A very rude awakening

skin in the game

A risk management measure of a purchaser's stake in an investment, such as a homebuyer's down payment on a home purchase.

It is all about expectations: do I need to save to become a homeowner, or not? Either way, more than half of California households become homeowners – much higher in central states. Thus, the issue of a down payment does not change their decision to buy or not to buy. It will, however, cause many to begin saving earlier and continue saving longer to meet their goal of homeownership.

The dream, deferred for reason

The disastrous consequences of the Millennium Boom precipitated the passage of Dodd-Frank. The creation of the *Consumer Financial Protection Bureau (CFPB)* heralded the shift from the loose-lending era to a paradigm of protection for the consumer from abusive lending practices that adversely affected society and our institutions.

This is the first time in America's long history the government has positioned itself between lender and homebuyer to advise the homebuyer about the best direction when considering a mortgage. This is a direction the homebuyer's agent would have separately suggested.

Does saving for homeownership threaten the American Dream?

Hard times and hard rules pave the path towards more *responsible homebuying*. However, this is often met with resistance by those who think short-term and are not mindful of today's difficult recovery, which followed a very deep recession bordering on a 1930's depression but for government assistance programs, topped off with a debilitating global financial crisis that has yet to be cured.

Opponents of the QRM rule claimed that requiring prospective homebuyers to save for a 20% down payment is an insurmountable goal for many potential first-time homebuyers. This, in turn, will lead to lower rates of homeownership and a rip in the societal fabric. It's all very bleak and emotionally compelling. But is it true?

Not really. The recession and its many privations have not managed to strike the desire for homeownership from the American ethos. Americans still *crave homeownership*. In many cases, they do so in spite of their own observations and the risks to financial wellbeing.

Thus, agencies in control of the real estate process and the lenders of mortgage monies have a responsibility to craft a sustainable path to homeownership, one good for both booms and busts.

Part of this path is a healthy investment by buyers in the property purchased — the 20% down payment. It's not the easy route, or the popular one. However, the easy and popular route ended in an unprecedented number of foreclosures and negative equity assets. It has become clear that the few controls over mortgage lending remaining in place during the Millennium Boom were inadequate as an avuncular means of reaching a buyer's long-term homeownership goals.

For a loan to be considered a *QRM* under the first proposed definition, the homebuyer needed to bring in a minimum 20% down payment. However, the final QRM rules had *no down payment requirement*, a huge miss for stabilizing the mortgage market. Thus, a return to higher savings rates will not originate in new housing regulations.

Even if the QRM had required a minimum down payment requirement, homebuyers still have many ways to get around providing significant down payments. In lieu of conventional financing, many first-time buyers opt for **Federal Housing Administration (FHA)**-insured financing. FHA-insured loans have more permissive underwriting standards, but require mortgage insurance premiums (MIPs). And, the minimum down payment requirement for an FHA-insured loan is only 3.5%.

Further, Fannie Mae and Freddie Mac now accept minimum down payments as low as 3%. However, as stricter credit standards are set across the mortgage industry during our present recession, tighter access to credit is keeping many homebuyers who were qualified even a few months ago from qualifying today. These would-be homebuyers will need to return to the drawing board for the next year or two, increasing their savings and improving their credit scores before they can take on homeownership.

Mortgage regulators have cracked down on wayward purchase-assist lenders who reigned in the 2000s. Two rules which took effect in 2015 affect consumer mortgage lending:

- qualified residential mortgages (QRMs), which focus on lender risk retention under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank); and
- qualified mortgages (QMs), which focus on underwriting standards and provide a safe harbor option for lenders to automatically comply with ability-to-repay rules under the Truth in Lending Act (TILA).

The 20% down payment, once the standard for consumer mortgages, became a quaint novelty during the fevered years of the Millennium Boom. Homebuyers (and lenders) got used to the easy days of purchasing a home with 3.5% down, 0% down or even 0% down plus seller-paid or financed closing costs.

qualified mortgage (QM)	pg. 139
qualified residential mortgage (QRM)	pg. 140
skin in the game	pg. 143

The future of saving

Chapter 9.1 Summary

Chapter 9.1 Key Terms

Chapter 9.2

Income inequality harms California's housing market

Learning Objectives

After reading this chapter, you will be able to:

- identify California's typical household characteristics;
- compare the number of homes needed per individual in California versus the U.S.; and
- explain ways to lessen the effects of income inequality in California.

Key Terms

gross domestic product (GDP) **income inequality**

California's household demographics

The fuel for California's housing market is new **household formations**, reliant not just on population growth, but on that population's access to quality jobs and sufficient wages. [See Factor 1: Jobs]

Figure 3 displays today's typical California household makeup.

Just under one in two households in California are headed by married couples. Roughly one in four consist of a single person living alone. The rest are made up of those living with non-relatives (roommates or cohabiters) and individuals heading family households with no spouse present (single parents, adult children taking care of elderly parents, etc.).

These percentages are largely unchanged since last decade, despite the brief jump in household size following the Great Recession when family members consolidated households to save money.

The average U.S. household looks significantly different from California's household:

- 60% of U.S. households consist of married couples, well above the 49% in California; and
- 17% of U.S. households are single-person households, well below the 24% in California.

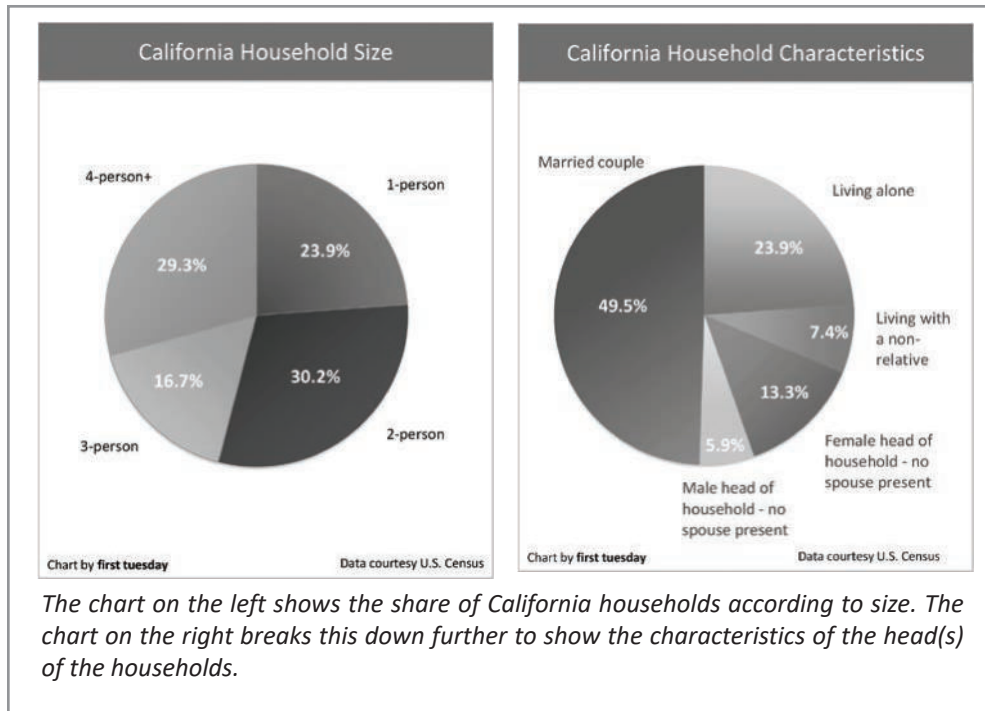


Figure 3

California Household Size and California Household Characteristics



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The Golden State's tendency toward single-person households ultimately translates to a need for more housing units per individual here in California. Further, these housing units look different than the housing units of most married couples, as single-person households generally:

- make less money than married households; and
- desire less space than married couples.


The average **single-person living alone** earns 34% of what married couples living together make. And that's not just because in many married households both couples work — households consisting of **non-relatives living together** (that are just as likely to feature multiple workers) earn 47% of what the average married couple household makes. This suggests that married individuals tend toward higher earnings, one reason being the tendency to wait until financial stability before marrying. [See Figure 4]

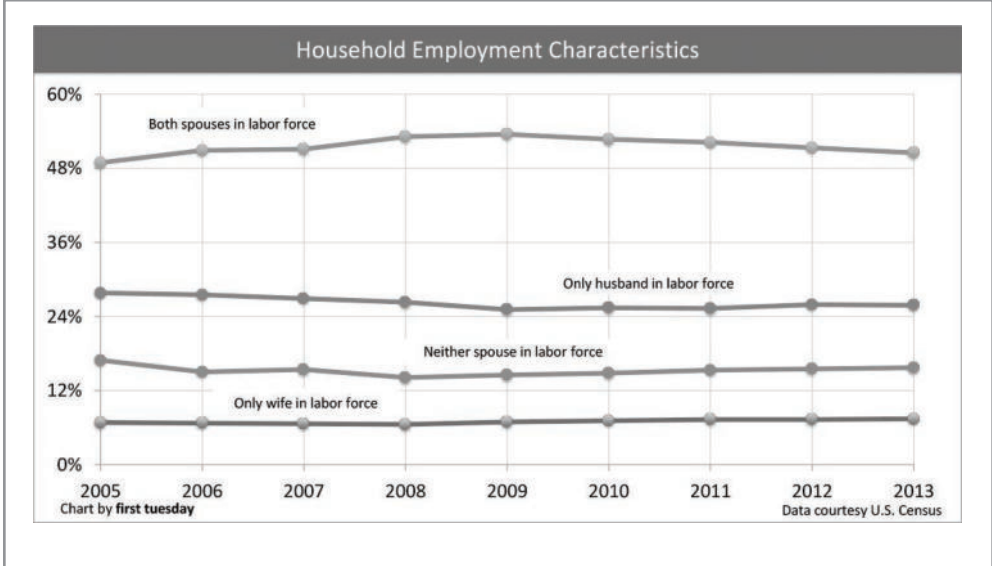
While California has a need for more housing due to the greater number of single-person households, these "extra" housing units are more likely to be less costly **multi-family** dwellings, including condominiums and rental units in apartment buildings in city centers.

Further, this dynamic of young adults waiting to settle down and form households is only expected to increase through the next few years — peaking in the years following the recovery from the 2020 recession, likely around 2024-2025. The young generation of would-be first-time homebuyers (Generation Y, or Gen Y) has been forced to put off homeownership due to a delayed entry into the workforce in the aftermath of the Great Recession and persistent low wages for failure of employer revenues to trickle down to employees.

**California's
unique
housing
needs**

Figure 4
Household Employment Characteristics


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These young adults born in the 1980s and 1990s are often found in urban centers, living with roommates, renting rather than owning. The average homeownership rate for Californians aged 34 and younger is only 20%-40%, depending on the county. Before the Great Recession, the homeownership rate for this age group was five to ten percentage points higher.

Today’s depressed homeownership rate amongst young people translates to a lot of lost home sale transactions. **Real estate agents**, builders and mortgage lenders wait anxiously while Gen Y slowly accumulates the savings and income needed to realize their full potential for homeownership.

Smaller paychecks, smaller houses

It’s easy to wave away Gen Y’s plight and now that of Gen Z as a young person’s problem, or a blip in an otherwise healthy labor force here in California. In truth, average incomes started falling behind in California long before Gen Y and later Gen Z came of age, stagnating household formations and in turn weighing down home sales volume. [See Figure 5]

gross domestic product (GDP)
The market value of all goods and services produced within a country calculated over a set period of time.

Accounting for inflation, California’s **gross domestic product (GDP)** increased by 108% 1997-2019, at \$2.8 trillion in 2019. During the same time, average per capita income in California rose a meager 50%. In other words, California GDP is growing at a rate over twice as quick as personal income. [See Figure 5]

GDP is the measure of a state’s total economic output, and a general indicator of broad financial health of its population. However, it clearly does not translate directly to income growth for employees.

income inequality
The uneven distribution of wealth across the population.

A very small amount of the difference accounts for things like indirect business taxes and bad debts. But the bulk of the difference is due simply to a business owner’s profiting disproportionately to the wage earners who work for them — a situation known as **income inequality**.

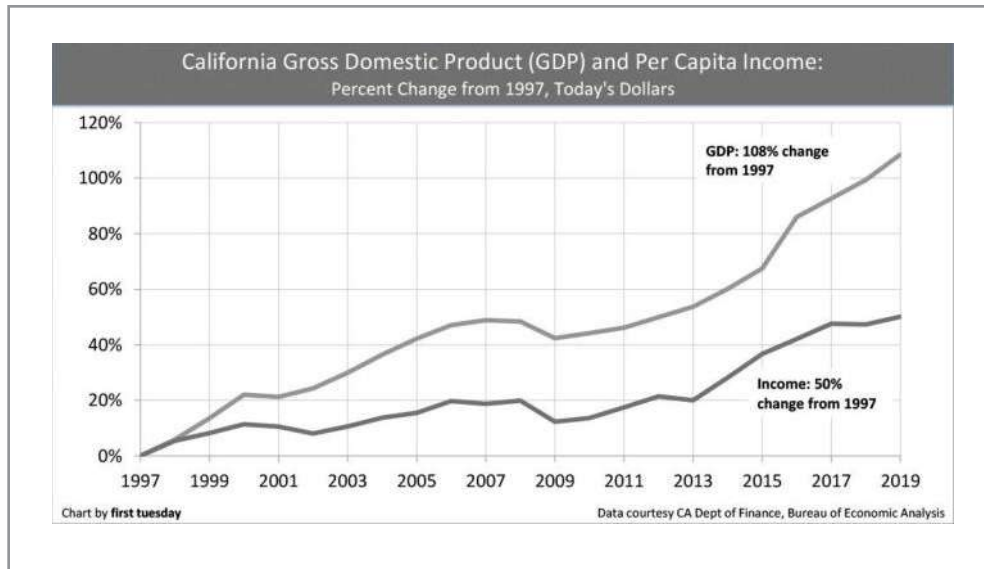


Figure 5

California Gross Domestic Product (GDP) and Per Capita Income: Percent Change from 1997, Today's Dollars

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Here in California, the average income of the top 1% of earners is 31 times greater than the average income of all other earners, according to the Economic Policy Institute.

Income inequality is not only bad for most income earners; it's also bad for California's economy. In fact, without today's high level of income inequality in California and the U.S., GDP would actually be significantly higher, according to a study on the link between GDP and income inequality by Organization for Economic Cooperation and Development. [See Figure 6]

Another way to weigh the effect of income inequality on the housing market is to consider the housing demands of 99% of California's workers against the top 1%. Sure, the top 1% of earners will buy more expensive homes, and often buy a vacation home or two on top of their primary residence. They may even become real estate investors, buying dozens of properties.

But that is not even a drop in the housing bucket compared to the housing needs of the 99-percent-ers, which going into 2021 nears 16.4 million working individuals in California. They are the stakeholders in the companies employing them.

When profits are distributed just a little more evenly between stockholders and stakeholders (employees), the purchasing power of the bottom 99% rises. This causes a considerably positive effect on the price of rents and sales in the housing market, as workers can qualify for higher rents and mortgages, and household formation increases as individuals finally gain the income needed to move out on their own or with others.

Policy changes affecting income inequality usually take the form of changes to the **tax code**. However, these wealth taxes can be unpopular — despite the truth that:

Income inequality: bad for the economy, bad for housing

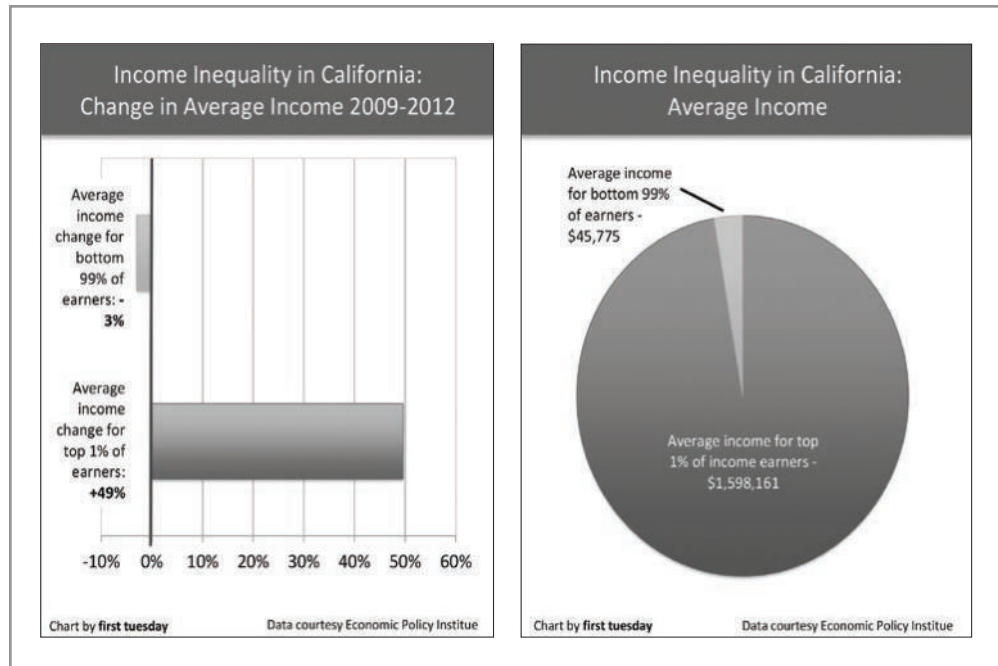
Share the wealth, it's vast

Figure 6

Income Inequality in California: Change in Average Income 2009-2012 and Average Income

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- most all households, the 99%, are well out of danger of ever being subject to such wealth taxes; and
- the super wealthy are no more worthy of protection from taxes than regular taxpayers, though this is currently the case.

Don't misunderstand. The top 1% of income earners are neither "bad" people nor purposefully keeping profits out of the hands of employees. But there's no denying our tax code is set up to favor the wealthy living in our society.

For regular income earners, it's mandatory to give 10%-28% of annual income to the federal government in income taxes each year, on top of sales and state taxes. For the top income earners, the tax rate is 39.6%. However, due to several **tax loopholes** designed by their applicability to favor the wealthiest taxpayers, the paid rate for the wealthy ends up much lower.

Make positive changes to the tax code to address income inequality, and you'll see more workers making it into the middle- and upper-class of income earners. You'll also see a higher, self-sustainable homeownership rate. California's homeownership rate is consistently ranked near the bottom of the nation, at 55% going into 2021.

Uphold the status quo, and you'll continue to see the rift widen between the top income earners and average earners. GDP growth won't realize its full potential, large corporations and stockholders will flourish and small businesses and the real estate industry will struggle. And in return, the rich will get richer; everyone else will become poorer, generating a reduced standard of living.

California's unique housing demands don't always match up with the income of its residents. Income inequality is catching up with the economy, specifically the housing market.

While California has a need for more housing due to the greater number of single-person households, these "extra" housing units are more likely to be less costly multi-family dwellings, including condominiums and rental units in apartment buildings in city centers.

GDP growth does not translate directly to income growth.

Income inequality is not only bad for most income earners; it's also bad for California's economy.

For regular income earners, it's mandatory to give 10%-28% of annual income to the federal government in income taxes each year, on top of sales and state taxes. For the top income earners, the tax rate is 39.6%. However, due to several tax loopholes designed by their applicability to favor the wealthiest taxpayers, the paid rate for the wealthy ends up much lower.

gross domestic product (GDP)	pg. 148
income inequality	pg. 148

Chapter 9.2 Summary

Chapter 9.2 Key Terms

Notes:

Factor 10: Construction



Single family residential (SFR) and multi-family construction



Chapter 10.1

After reading this chapter, you will be able to:

- understand the details of current single family residential (SFR) and multi-family construction starts; and
- develop an opinion on the nature of construction starts in 2021 and beyond.

None of the material in Chapter 10.1: Single family residential (SFR) and multi-family construction will be covered in the quizzes or final examinations for this course as construction data is highly susceptible to constant change.

construction starts

After two years of decline, single family residential (SFR) starts turned positive, up 31% above one year earlier in the six-month phase ending June 2021. During those same six months, multi-family construction starts also reversed course, up 26% from a year earlier.

Learning Objectives

Key Term

The trend in California construction starts

Multi-family construction experienced a 9% decrease in 2020 from the prior year, totaling 47,000 new units started. Demand for multi-family rentals has generally been higher during this past decade compared to new SFRs. But, on top of the unique pandemic-induced obstacles facing builders in 2020-2021, new multi-family construction continues to hit roadblocks in the form of outdated zoning and vocal not-in-my-backyard (NIMBY) advocates.

SFR construction starts were roughly level with the previous year in 2020, totaling 59,000 new SFRs started. SFR construction will slow in 2021, the result of a damaged economy and cautious builders. Further, compared to the 150,000 SFR starts achieved in 2005 at the height of the boom, the 59,000 SFR starts achieved in 2020 is a fraction of what is needed to meet demand.

State-initiated legislative efforts to add to the low- and mid-tier housing stock have focused on encouraging more multi-family construction in recent years. As a result, metro areas with the highest annual increase in construction include Sacramento, Bakersfield and San Diego. At the same time, the deepest losses have been experienced where zoning remains restrictive for this type of housing, including in San Francisco, San Jose and Los Angeles.

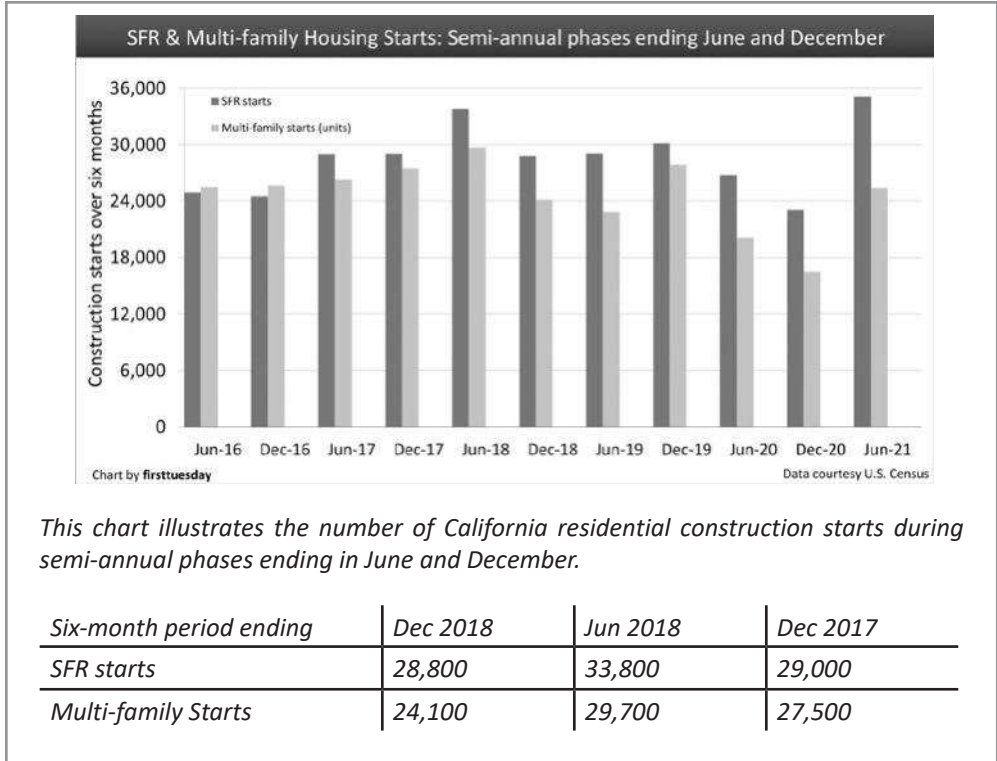
After over a year of social distancing and tightened lines of credit, builders are finally cashing in on legislative incentives and rising homebuyer demand. However, job losses have made builders cautious, watchful for the inevitable fallout from the expiration of the foreclosure and eviction moratoriums, to put downward pressure on home prices and rents heading into 2022. All of these factors will combine to hold back multi-family starts from reaching their full potential for the next two-to-three years.

Detached SFR construction trends in California

- 35,100 SFR starts took place in the six-month period ending June 2021. This is 8,300 more starts than occurred during the same period one year earlier, a 31% increase.
- 49,800 SFR starts took place in 2020. This is down 16%, or 9,400 starts, from 2019.
- 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.
- Final reports issued for new subdivisions by the California Department of Real Estate (DRE) have declined during the past 12 months.

Detached SFR forecast

- **Realty Publication's** forecast for total SFR starts in 2021-2022 is most affected by the downward pressure placed by the recessionary jobs market.
- SFR starts fell back in 2020, as builders adjusted to social distancing restrictions, slowing sales volume and tightening access to credit. Expect SFR starts to remain low in the next two years, until the recovery begins to pick up steam, likely around 2023-2024.
- Subdivision final reports will continue to decline as developers until sense a return of home buyers is on the horizon.



This chart illustrates the number of California residential construction starts during semi-annual phases ending in June and December.

Six-month period ending	Dec 2018	Jun 2018	Dec 2017
SFR starts	28,800	33,800	29,000
Multi-family Starts	24,100	29,700	27,500

Figure 1
SFR and Multi-family Housing Starts: semi-annual phases ending June and December

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- The next peak in SFR starts will likely occur during the next boomlet of 2024-2025.
- 25,400 multi-family housing starts took place in the six-month period ending June 2021. This is 5,300 fewer starts than occurred during the same period one year earlier, an increase of 26%.
- 36,000 multi-family housing starts took place in 2020. This was 28% lower than 2019.
- 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.
- **Realty Publication’s** forecast for multi-family housing in 2021-2022 is a roughly level number of starts with 2020. As the jobs recovery is still stuttering in 2021, lenders continue to keep a tight fist on funds, hampering builders.
- Multi-family housing starts were expected to rise at a gradual pace in 2021-2022, as several legislative changes aimed at increasing multi-family construction encourage more building of dense, low- and mid-tier housing. However, social distancing restrictions and tightening lines of credit pushed multi-family construction numbers down significantly in the first half of 2021. These obstacles are gradually lessening as jobs are slowly recovered.

Multi-family housing construction trends

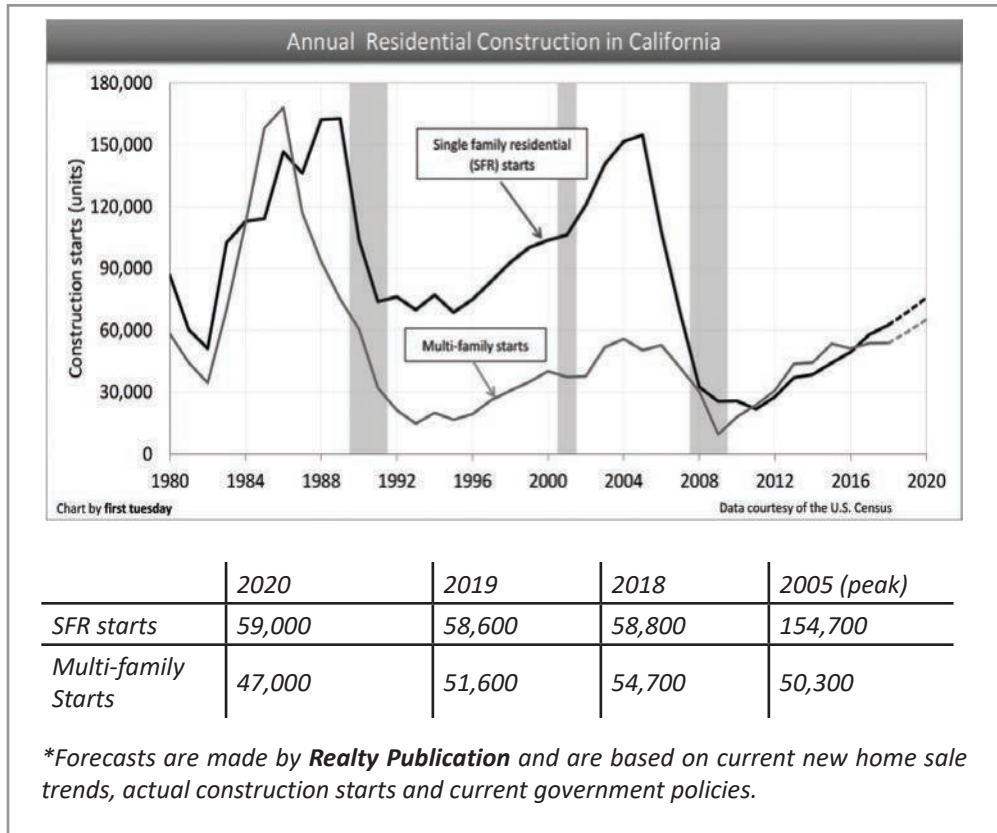
Multi-family housing forecast

Figure 2

Annual Residential Construction in California



[Click to watch](#)



Statistics related to California housing

- The next peak for multi-family housing starts is likely to occur around 2024-2025, with the full recovery of all jobs lost to the 2020 recession and a crest of the next housing boom.
- 14.4 million total housing units existed in California in 2019, 13.2 million of which are occupied and 7.2 million of which are owner-occupied, according to the U.S. Census Bureau. This continues a slight increase over prior years.
- California population growth is increasing at a rate of 0.5%-1% per year, having declined slightly each year since 2014. In 2020, California's population declined for the first time in memory.
- 16.4 million people were employed in California in July 2021. This is 1.3 below the number of jobs held a year earlier, according to the California Employment Development Department (EDD).
- The rental vacancy rate averaged 4.1% in 2020.

construction starts
Building permits issued before builders may begin construction.

Construction starts will not rise significantly until jobs have recovered from the 2020 recession. The pace of this rise is dependent on several factors, discussed below.

End user homebuyer-occupant demand is the ultimate determination of how construction starts for SFRs and condos will shift as we move through the impacts of the 2020 recession and, eventually, into recovery. Builders rely on buyer-occupants to support new SFR home construction. Discouraged by high home prices and rising lumber prices, buyer-occupants are hesitant to purchase a new or resale home in 2021. However, this caution is somewhat tempered for new construction by unmet demand due to extremely low home resale inventory throughout 2020 and 2021.

End user demand drives construction

Builders will customarily bide their time until figures for home sales volume by buyer-occupants, not speculators, pick up. This won't occur until buyers sense the recession is over and home prices have bottomed, likely to occur around 2023. Then, it takes 12-18 months for construction numbers to react to rising homebuyer demand. Therefore, construction will likely pick up steam around 2024-2025.

As in any recovery from a recession, builders will have to deal with **speculators**. When speculators interfere, home sales volume and pricing display a distorted picture of long-term demand trends. However, builders need to look to jobs data, mortgage rates and inventory levels in low- and mid-tier housing as the primary impetus for demand when they set the level of starts that will most likely sell. [See Factor 3: Real estate speculation]

California recovered the number of jobs lost in the 2008 recession six years later in 2014, but the recovery for incomes was far behind. Further, considering the intervening population gain (around 3 million), full employment and labor force participation comparable to the December 2007 peak was not reached until late-2019 — just in time for the next recession to arrive in February 2020 and scoop away years of job build-up in a matter of weeks.

How do builders decide when and where to build? Builders analyze existing home sales, end user demand and local employment. Together, an analysis of these and ancillary factors produces a prediction of future construction trends.

Obstacles for builders

While end user homebuyer-occupant demand is the ultimate driver of construction starts, several obstacles face builders in 2021-2022 that will determine the pace of SFR and condo starts. Builders rely on buyer-occupants to support new home construction. Discouraged by low inventory, high home prices and rising interest rates, buyer-occupant demand to purchase a home in 2018 remained stunted through 2019. However, 2020 saw interest rates plunge to record lows, which boosted buyer interest, a need unfulfilled by available resale homes since sellers remained timid in 2020. Yet, builders were largely unable to meet homebuyer demand due to social distancing measures and tightened access to credit.

Obstacles of concern to future construction starts include:

- the historic job losses of 2020, which will take years to recover;
- tightened credit for homebuilders;

- beginning in 2023, rising mortgage rates, to reduce homebuyer borrowing capacity; and
- restrictive zoning regulations, which discourage density in desirable living areas.

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 remain low until most of these factors collectively improve, expected around 2024.

Chapter 10.1 Summary

Multi-family construction experienced a significant 28% decrease in 2020 from the prior year, totaling 36,600 new units started. Demand for multi-family rentals has generally been higher during this past decade compared to new SFRs. But, on top of the unique pandemic-induced obstacles facing builders in 2020-2021, new multi-family construction continues to hit roadblocks in the form of outdated zoning and vocal not-in-my-backyard (NIMBY) advocates.

SFR construction starts also saw 2020 totals lower than the previous year, turning in a 16% decrease from 2019. SFR construction has reversed course in 2021, the result of increased homebuyer demand and low home resale inventory. Compared to the 150,000 SFR starts achieved in 2005 at the height of the boom, the 49,800 SFR starts achieved in 2019 is a fraction of what is needed to meet demand.

Chapter 10.1 Key Term

construction startspg. 156

Blueprints for future construction

Chapter 10.2

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.

savings rate

zoning

tenants-by-foreclosure

Learning Objectives

Key Terms

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

The need for government action

Real estate price movement influenced by local government

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]

Greater urban density through zoning

zoning

Building and land use restrictions enacted by local policy makers to ensure a consistent flow of improvements to meet the demand of population growth.

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 home price boom, expected around 2024-2025, 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 8: 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

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 look beyond 2021, 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 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

Reduced permit costs

Restrain economically misplaced building

Old mortgages, savings and mortgage debt

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]

Increased savings rate

savings rate

The percentage of an individual's monthly disposable income which is not spent.

Meanwhile, **personal savings rates** are in a weak position in 2021, having peaked in 2020 with the arrival of stimulus checks and consumers' caution against spending. However, the savings which many accumulated during 2020 and again in 2021 with the second and third round of stimulus checks will gradually become depleted as the fallout from the 2020 recession continues to be extended. Further, the low savings rates of the past decade 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 12% 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)*.

Sales volume and equilibrium pricing

Before SFR construction can rise, homeowners need to believe that buying a home is an economically beneficial decision. Going into 2022, home sales volume remained just above the seven-year low experienced in 2014, having remained mostly flat-to-down 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. Sales volume has either flattened or decreased slightly each year since then.

429,200 new and resale home transactions closed escrow in California during 2020, roughly level with 2019, despite a steep drop in sales mid-year. For comparison, 2020's sales volume was 42% below the peak year of 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 for 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.

While property prices continued to rise in 2020, they are headed into a decline going into 2022, the result of the foreclosure moratorium expiration. Once prices recover, look for home prices to rise haltingly in the coming decade as they did between 1945 and 1964 (the years the Boomers were born). In the years following 2023-2024, home prices will likely rise closer to the rate of consumer inflation, an acceptably steady 2% to 3% 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 2024-2025.

This drop in the homeownership rate represents the fallout from roughly one million families who had owned and occupied homes in California before

Equilibrium pricing crossover

tenants-by-foreclosure

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.

Construction in the future

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. 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 6: Renting: the alternative to homeownership]

**Where
construction
will blossom,
and where it
will wither**

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 21: 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. 162
tenants-by-foreclosurepg. 163
zoningpg. 160

Chapter 10.2 Summary

Chapter 10.2 Key Terms

Notes:

Factor 11: Inventory



California's vacant residential properties

Chapter 11.1

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)

Learning Objectives

Key Terms

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;

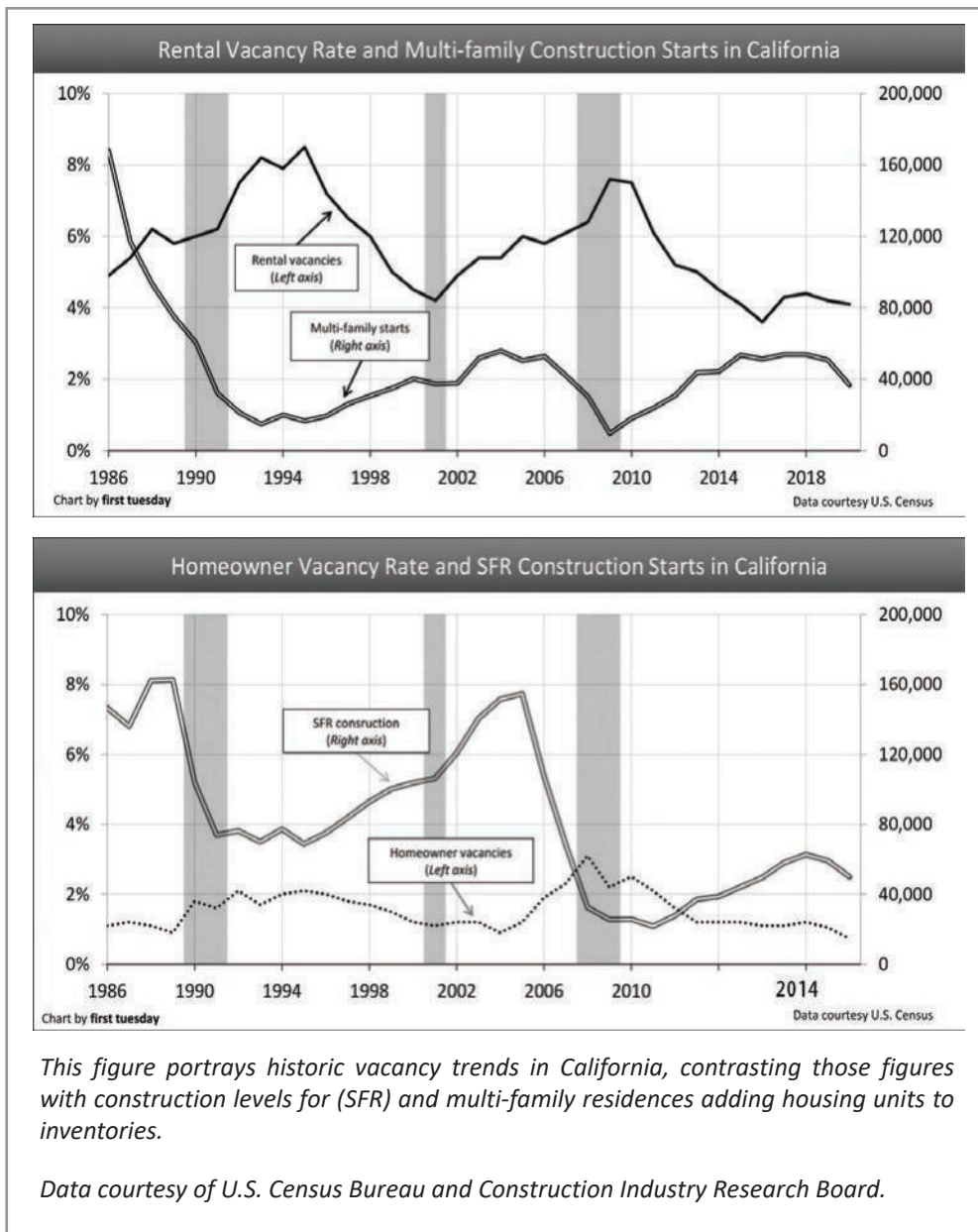
More housing than people, but diminishing

Figure 1
 Rental Vacancy Rate and Multi-family Construction Starts in California
 and
 Homeowner Vacancy Rate and SFR Construction Starts in California


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



 [Click to watch](#)



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

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.

A look at trends driving vacancies during the 2008 recession, recovery cycle and today provide a glimpse into what vacancies can tell us about the direction of the current recovery.

The relationship between homeowner and rental vacancies is one of *undulating equilibrium*. When home prices are high and it makes more financial sense to rent, vacancies in rental housing go down and homeowner vacancies go up.

Other factors can influence this equation, like the massive foreclosure and short sale crisis that ruled the housing market following the 2008 recession. Over time, the dominance of one type of housing (homeowner vs. rental) is equalized by a shift in favor of the other type of housing, a fact borne out by simple arithmetic.

In California, recording a **notice of default (NOD)** is the first step in the foreclosure process. The process ends when the property is sold at a *trustee's sale*. In some cases, these trustee's sales result in the property being sold back to the lender and then resold as real estate owned (REO) property, to remain vacant for months. However, in 2013, speculators bought up homes at foreclosure sales, reducing the number of vacancies – particularly homeowner vacancies.

As more and more individuals continue to favor rental housing, the **demand** for rental housing causes landlords to increase rents to maximize profits. This, in turn, eventually translates into more lucrative conditions for **homeownership**, as well as construction opportunities for builders and investors.

Builders took advantage of the lush lending conditions of the early and mid-2000s. As a result, they introduced massive inventories of SFR housing units into the market with relatively little durable demand by **end users**.

Undulating equilibrium

Trends in residential vacancies

notice of default (NOD)

The notice recorded to begin the nonjudicial foreclosure process. [See **RPI** Form 471]

Uneasy building fueled the building rampage

By the mid-2000s, the historical trends pulling on both types of vacancies were jolted loose by rapacious mortgage money management and vacancies became unanchored, to soar as they did.

The introduction of new housing units into the homeowner/rental vacancy equilibrium is not in and of itself a disruptive event. This is simply because the California population grows (consistently around 1% annually since 2001, and at the moment primarily comprised of net births over deaths). However, the sheer volume of SFR construction introduced into the housing-saturated *Millennium Boom* real estate market was not only disruptive, but disastrous.

A brief history lesson will demonstrate how builders got carried away. In the early 2000s, just as the economy was beginning to slip into a corrective recession, the **Federal Reserve (the Fed)** stepped on interest rates to stimulate growth in hasty reaction to perceived business recession due to the September 11, 2001 terrorist activities. The Fed change in monetary policy did not allow the ongoing 2001 recession to complete its work to cool down excessive real estate prices brought on by the recovery in 1998.

These low interest rates encouraged lenders to lend — which they did in spades through Wall Street bond market funding. The Fed later took no steps to withdraw the excess funds they had prematurely pumped into the banking system after September 11, 2001.

The money flowed like wine, luring all manner of borrowers to gulp from the proffered cup. Among those who drank most deeply were **builders**. They borrowed and built since money was available from local bankers to do so. For, contrary to popular belief, builders do not build in anticipation of current or future housing demand. Rather, they build because there is money available for them to do so.

Editor's note — Observe that even as the rental vacancy rate rose, builders did not cease their building of multi-family apartment buildings. The expense and scope of building multi-family units kept that boom from reaching the proportion of the SFR building spree, but it nonetheless illustrates the unrealistic doggedness of builders with money. [See Figure 1]

When the **Millennium Boom** began in earnest in 2002, more people began to jump on the homebuying bandwagon. Naturally, rental vacancies began to rise. However, the **homeowner vacancy rate** began to rise uncharacteristically with rental vacancies, even during 2004-2006 when buyers (users, buy-to-let investors and speculators) were all pouring into the market at the same time. The concurrent increase in construction of residential units kicked homeowner vacancies to upwards of an unprecedented 3% level by 2008.

homeowner vacancy rate

The percentage
of unoccupied
homeowner housing
units.

Heavy residential vacancies, an indicator of an improperly functioning local economy, were the norm from 2006-2011. These vacancies blighted neighborhoods and provoked crime, destroying the wealth of neighboring homeowners. Vacancies gradually returned to normal during the long recovery from the 2008 recession. However, in 2020, homeowner vacancies averaged 0.7%, their lowest level since the Census began tracking the statistic in the 1980s. For reference, homeowner vacancies typically rest near 1.2%.

The vacancy rate to which residential rental properties return in California is roughly 5.5%, a pivotal figure for property managers and investors (in 2020, it averaged 4.1%). Homeowners are less likely and, in many recessionary real estate markets, simply unable to sell, pack up and move, tethered to their homes by property price corrections, negative equity and a dearth of users as buyer-occupants.

Like homeownership vacancies, the **rental vacancy rate** varies above and below this pivotal mean figure depending on conditions of a full recovery or a recession. Presently, the rental vacancy rate is below normal. This decreased rate was once due to above-normal homeowner vacancy rates — those who either lost their homes or decided to put off homeownership after the Great Recession but still needed a place to live and have filled up rental properties. During the past decade, the low rental vacancy rate has been partly attributed to the slowly recovering **construction industry**, which while growing, failed to keep up with rising demand for rentals. Strict zoning regulations in desirable areas limit new multi-family housing.

In 2020, rental vacancies were also below normal, at 4.1% in 2020, as the demand for rentals has outpaced new rental construction in the years following the foreclosure crisis. In 2020, the **homeowner vacancy rate** fell to 0.7%, its lowest level in recent memory.

The further declining average rental and homeowner vacancy rates are thanks to the eviction moratorium, which has kept renters housed despite the inability of many to pay following the job losses of the **2020 recession**.

As we make our way through yet another slow year for home sales, multiple listing service (MLS) **inventory** is emerging as a key component in California's housing market.

Inventory for sale recently rebounded from a record low, averaging 23% below a year earlier as of July 2021, across California's largest metros. The winter months typically see the lowest inventory of homes for sale, peaking around mid-year. In 2020, the mid-year peak in active listings was 21% below 2019's peak. [See Figure 2]

2021's inventory decline continues to be steepest in Riverside, which had 24% fewer listings than a year earlier as of December 2020. On the other hand, San Francisco and San Jose both saw very slight increases in inventory for sale compared to the prior year. Still, since these northern cities make up a

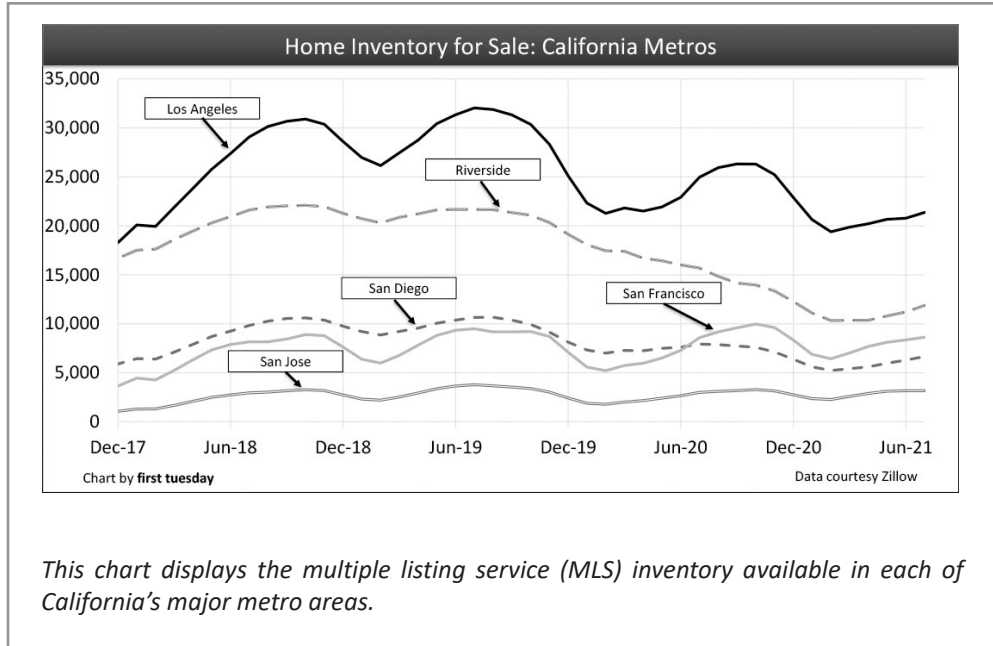
Vacancies during the 2020 recession

rental vacancy rate
The percentage of unoccupied rental housing units.

Homebuyer demand continues to outpace inventory

Figure 2
Home Inventory for Sale: California Metros

ONLINE UPDATE
Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



comparatively small portion of California’s housing market, their higher inventory is an anomaly compared to the sea of declining inventory across most of the state.

Looking forward, expect inventory to climb heading into 2022. Many would-be sellers have held off listing while they remain protected by foreclosure moratoriums, which expired at the end of July 2021, and forbearance programs, which are seeing expirations pile on in the second half of 2021. As these expirations snowball, more and more will turn to forced sales, increasing inventory. Today’s seller’s market will begin to tip in Q4 2021 as inventory grows and homebuyers start to take a wait-and-see approach to buying.

California’s volatile housing market

Here in California, homes typically leave the market more quickly than in more stable markets.

This is reflected in the average number of days a home sits on the market in California before being snatched up by eager buyers. In December 2019, the average number of days a home sat on the market before achieving a “pending” status was 32 days. Flash forward to December 2020 and the average home for sale in California’s largest metros was listed for just 14 days before pending.

This supply-demand imbalance has pushed home prices higher in recent years, even in 2018-2019 when interest rates were still rising. Average California home prices were 10% higher in 2020 than the prior year and have increased to 23% higher than a year earlier as of mid-2021. Expect prices to take a turn in 2022, the result of the expiring foreclosure moratorium and the

build-up of serious delinquencies. Home prices won't recover until all jobs lost to the 2020 recession have been regained, not likely to occur until around 2023-2024.

While supply and demand are momentarily disrupted following the **2020 recession**, when the dust settles and economic progress returns, the inventory shortage will rear its head again. There are only two reasonable possibilities to cure California's **long-term inventory imbalance** and general housing crisis:

- *decreased demand*, via a reduction in the number of homebuyers; or
- *meeting current demand* with more new construction.

The years beyond 2021 will see a bit of both.

2020-2021 experienced the triple whammy of a pandemic, recession and financial crash. Renters and homeowners alike were unable to make payments due to lost jobs and income. Government efforts to avoid mass evictions kept individuals housed through Q3 2021. But once the pandemic response subsides and the economy begins to find its footing, all of these missed payments will need to be repaid. The combined catch-up on housing payments will set back would-be homebuyers by years. Meanwhile, inventory will continue to swell as even homebuyers with sufficient income and ability wait on the sidelines for confidence in the economy to improve and prices to drop.

On the other hand, residential construction is due to increase, and soon. [See Factor 10: Construction]

Homeowner and rental vacancies are both near historic lows in California. Whenever vacancies decline, construction is sure to rise to meet demand. But construction has been hampered during this long recovery from the 2008 recession due to strict and limiting zoning laws in California's metro areas. To that end, several pieces of new legislation have passed since 2017 focused on providing more inventory to combat the housing shortage. These legislative changes include paving the way for smoother permitting and looser zoning laws.

The cure for the inventory shortage

Chapter 11.1 Summary

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.

Chapter 11.1 Key Terms

homeowner vacancy rate	pg. 170
notice of defaults (NOD)	pg. 169
rental vacancy rate	pg. 171

Factor 12: Pricing



California tiered home pricing

Chapter 12.1

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.

**debt overhang
price tier**

sticky pricing

Learning Objectives

Key Terms

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]

Price tier fluctuations

Editor’s note — Regional charts and further pricing commentary are also discussed in Factor 25: Regional housing indicators.

price tier

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.

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.

More accuracy with the multi-tiered lens

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.

Mathematical abstraction

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.

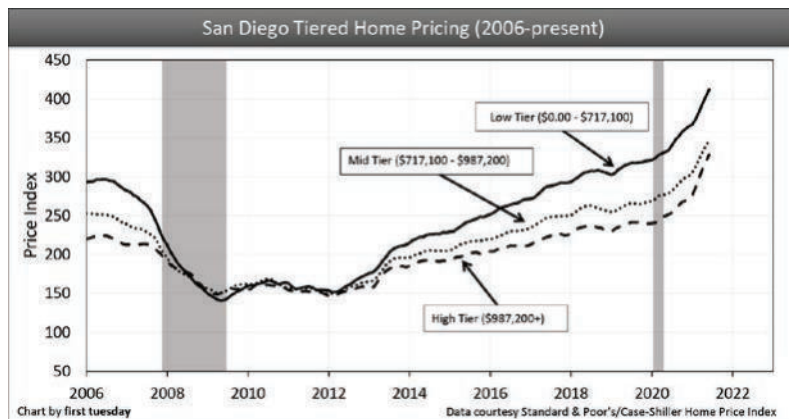
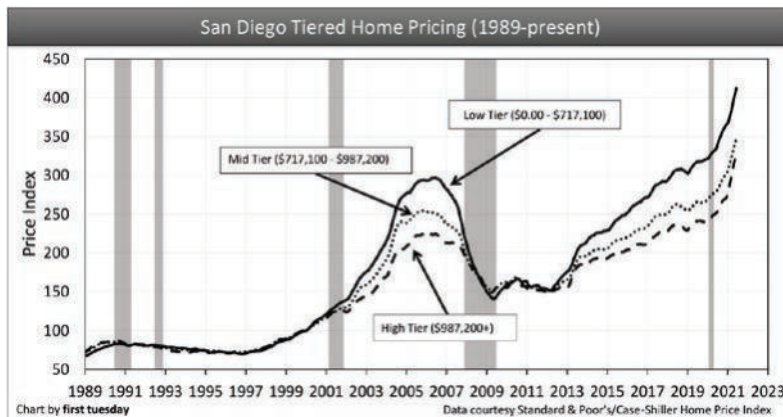
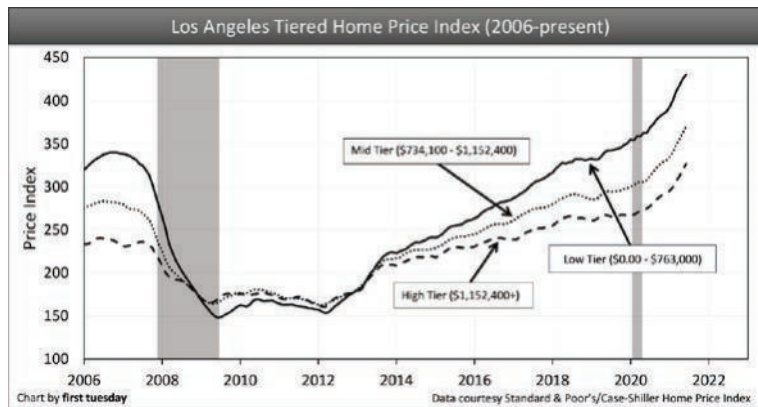
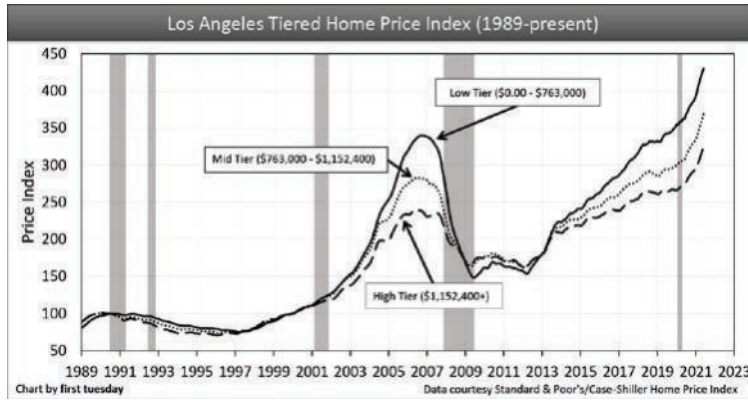



Figure 1
Los Angeles Tiered Property Price Index: 1989-Present & 2006-Present

and
San Diego Tiered Property Price Index: 1989-Present & 2006-Present


ONLINE UPDATE
 Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



 [Click to watch](#)

Figure 1
cont'd

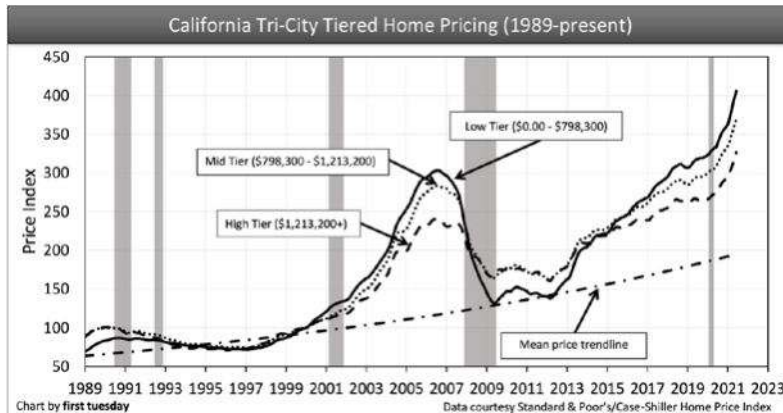
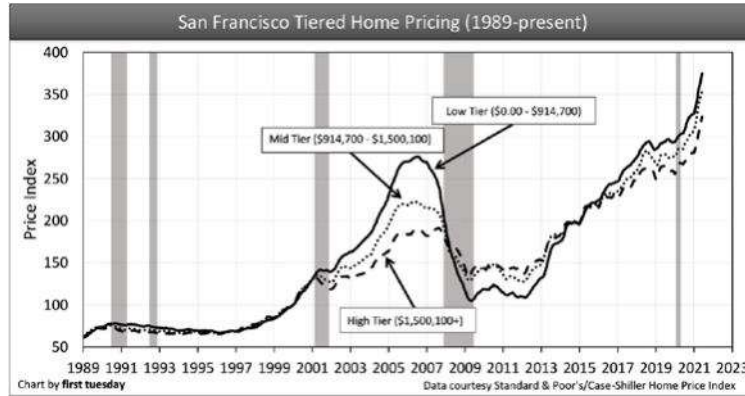
San Francisco
Tiered Property
Price Index:
1989-Present &
2006-Present

and

California Tri-
City Average
Tiered Property
Price Index:
1989-Present &
2006-Present



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



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.

Home prices continued to rise rapidly in all tiers across Los Angeles, San Diego and San Francisco during mid-2021. The statewide average for low-tier prices was 22% higher than a year earlier and mid- and high-tier prices were 23% higher. These significant price jumps continue to gain momentum, despite the continued impacts of the 2020 recession, specifically the 1.3 million jobs still missing in California as of July 2021. But without sufficient fuel from a jobs recovery, today’s rising prices won’t last.

In 2020-2021, historically low interest rates provided a boost for buyer purchasing power. These low interest rates, along with competition for a dwindling inventory of homes for sale, inflated home prices and sales volume in 2020, gaining speed in 2021.

Numerical alchemy in a median price for all

Prices reach their cyclical peak

However, expect today's high home prices to reverse course in 2022, the result of long-term job losses and high levels of 90+ day delinquencies. With the expiration of the foreclosure moratorium in Q3 2021, expect to see forced sales return, bloating inventory and increasing days-on-market and, soon enough, price cuts.

The housing market's performance in 2022-2023 will depend on the timing and extent of job creation, whether it be through government-sponsored programs or jobs returning organically over the next several years. Either way, the recovery of jobs is essential to returning some stability to the housing market.

Resistant to change

sticky pricing

A seller's irrational reliance on past home pricing as a basis for setting current pricing, called the money illusion.

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.

Search frictions and debt overload hindrance

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.

Excess mortgage debt

The second cause of a price adjustment lag is crippling load of excess mortgage debt underlying California's mortgaged homeowners, a condition called **negative equity**.

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 and elongated recovery, as took place in the years following the 2008 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.

debt overhang
Excess mortgage debt on a negative equity property.

Re-stabilized real estate market pricing and sales volume meeting the actual economic reality is a prerequisite for the commencement of a recovery. Yet it is made more difficult 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 initial home price drops and price recoveries 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.

A more stable livelihood for all

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.

If only we could stick to a cash price

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.

Pricing vs. objective reality

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.

debt overhang	pg. 181
price tier	pg. 176
sticky pricing	pg. 180

Chapter 12.1 Summary

Chapter 12.1 Key Terms

Chapter 12.2

A realty black hole

Learning Objectives

After reading this chapter, you will be able to:

- understand the psychological underpinning of the recent boom and bust in California; and
- identify key players in the final phase of a housing boom.

Key Terms

hit-and-run buyers

momentum traders

Belief in ever-rising prices brings implosion

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.

Perceived good time to buy

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.¹

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.

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.

Speculators lead the way to disaster

momentum traders
Buyers relying on the emotion of frenzied market participants, rather than property price inflation, to profit from buying and reselling property.

¹ "Momentum Traders in the Housing Market: Survey Evidence and a Search Model," by Monika Piazzesi

Hit-and-run buyers

hit-and-run buyers

Flippers who purchase real estate with the intent to quickly resell it at a profit produced by market momentum, not fundamentals.

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.

Real estate sandwichers

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 2018, over 2,000 new agent licenses on average were granted per month, continuing a steady annual increase since agent numbers plummeted during the 2008 recession. 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.

Home prices began to level off in 2018, but plunging interest rates in 2020 fueled a subsequent price increase in 2020-2021. Significant price increases will continue to draw in new agents, to fade when home prices wane with the building pressure of forced sales in 2022-2023.

Regular households become speculators

Licensees buy into the myth

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 Key Terms

hit-and-run buyers	pg. 186
momentum traders	pg. 185

Appraisals solely to qualify property as security

Chapter 12.3

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.

appraisal

fair market value (FMV)

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.

Learning Objectives

Key Terms

Justifying the buyer's price is another matter

appraisal

An opinion estimating a property's value on a specific date resulting from an analysis of facts about the property.

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.

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.

Appraisals under the Dodd-Frank Act

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.¹

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.

Thus, in practice, all the rules against interference with the subjective analysis of the appraiser are honored in the breach. Further, appraisers know

¹ 15 United States Code 1631 §129E

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.²

No financial interest in the appraised property

Fee appraiser, defined

² 15 USC 1639e(k)

Chapter 12.3 Summary

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.

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.

Chapter 12.3 Key Terms

appraisal	pg. 189
fair market value (FMV)	pg. 189

The mean price trendline: the home price anchor

Chapter 12.4

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.

mean price trendline

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*.

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

Learning Objectives

Key Term

The intersection of price illusion and reality

mean price trendline

A reflection of consumer inflation, to which property prices cyclically return.

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.

The mean price trendline = consumer inflation

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.

Three cities; three tiers

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]

The crossover moment

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*.

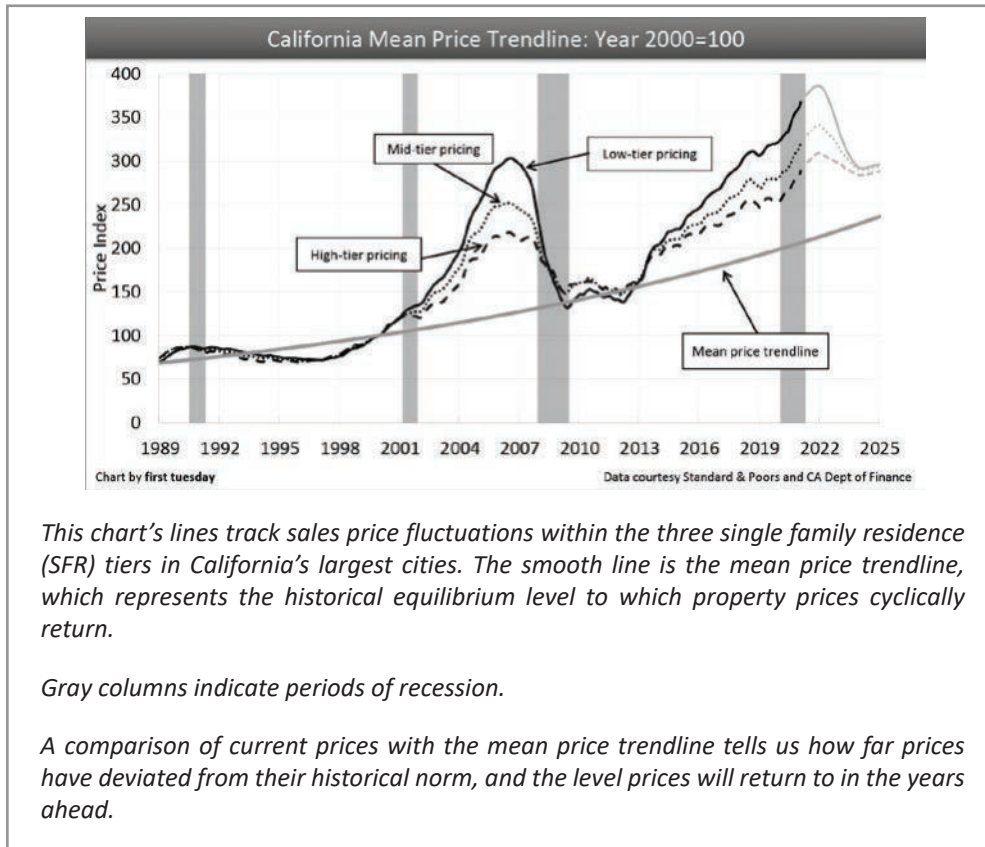


Figure 2

California Mean Price Trendline: Year 2000=100



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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.

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.

As evidenced by the past

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 the cyclically low 3.25% mortgage rates by 2012.

Editor's note — Interest rates diverged from the 60-year rate cycle in 2020, when interest rates hit historic lows. This brief but dramatic dip was a momentary departure from the longer rising trend that resumed course in 2021.

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.

Magnetic pull of the mean

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.

Frozen at the top of the peak

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, now that interest rates have bottomed and risen from their historic lows, the support for home price increases has disappeared. Further, with the expiration of the foreclosure moratorium occurring in Q3 2021, home price increases will be short-lived. Without fuel from decreasing interest rates and absent the support of a jobs recovery, the coming wave of forced sales will drag down home values beginning a few short months after the moratorium expires. All of this action is expected to pull prices down toward the mean price trendline in 2022-2023, flattening and rebounding in 2024 with the jobs recovery.

As prices begin to trend down, they will need to fall further still to be brought in line with homebuyers' ability to pay. In 2019, the Federal Reserve is continuing their process of raising interest rates to cool off the economy and induce a business recession, which experts forecast to arrive in 2020. All of this action is expected to continue to pull prices down toward the mean price trendline in 2019 and 2020, bottoming in 2021.

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.

The next price peak will occur in the years following 2024 when homebuyers and sellers return to the market in the recovery from the 2020 recession.

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

Prices always return to the mean price trendline

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.

Replacement cost paradigm

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.

This increased end user or homeowner demand for space in one location reflects the inherent desirability (and hence price) of raw land, but not the

cost of improvements. Also, the discovery of precious materials under or flowing through a parcel of land increases its value. However, such “Eureka!” discoveries are rare in modern California.

Thus, houses are just aggregates of *land, labor and materials* — the dollar cost of which is the replacement cost approach to valuation. The cost approach limits the price to be paid if comps and income approach methods suggest a higher price.

Home prices last bottomed in 2011, then increased rapidly from 2013 through 2018. Over the next 18 months, home prices continued to rise at a steadier 3%-5% annual pace closer to the inflation rate. However, by 2021 they had become far removed from the mean price trendline. This means fewer homebuyers are able to qualify due to prices rising faster than incomes.

RPI forecasts prices will reverse course following the expiration of the foreclosure moratorium, which occurred at the end of July 2021. [See Factor 23: Pandemic]

The next big peak in prices won’t be until after 2024-2025. These will be the years of the Great Confluence, when Baby Boomers, Gen Y and Gen Z return to California’s urban cores. Adaptable agents will continue to pursue the long-term and recession-proof occupations of income property management, residential income sales and mortgage financing (private or institutional). These are each consistent money-makers when there is a need to survive marketplace turmoil. People always need shelter and someone to arrange it.

The mean price trendline forecast

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.

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.

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.

Chapter 12.4 Summary

mean price trendline pg. 193

Chapter 12.4 Key Term

Chapter 12.5

Home price bumps congressionally fed

Learning Objectives

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.

Key Terms

Baby Boomer

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.¹

¹ 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.

The gates swung open with deregulation

Baby Boomer

The post-WWII generation responsible for a sharp increase in the U.S. population. Their collective activities have a sizeable effect on the market.

Further incentive to buy

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).

1990's tax loopholes and handouts run amuck

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.

Preparing for the future, with or without subsidy

As the Boomers' children (also known as **Generation Y** or **Gen Y**) and older members of the next generation, Gen Z, continue on their journey towards homeownership in the coming years, they face a very different economic climate built around future economic conditions flowing from 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' views on housing.

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]

Generation Y (Gen Y)

The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.

Pricing and the constraints on consumer inflation

Chapter 12.5 Summary

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.

An adjustable rate mortgage (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.

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.

In the 1990s, even more government housing policy encouraged homeowners to buy with the intention of profiting from a resale. In 1997, married homeowners were given a \$500,000 profit exclusion from paying taxes on the sale of their home.

By the early 2000s, property investors had discovered more advantages from the sale of their real estate. They could buy a very nice pride-of-ownership 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.

Chapter 12.5 Key Terms

Baby Boomer	pg. 201
Generation Y (Gen Y)	pg. 203

Factor 13: Stock market



S&P 500 as a complement to real estate

Chapter 13.1

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.

Baby Boomer

capitalization rate (cap rate)

dis-saving

net income multiplier (NIM)

price-to-earnings (P/E) ratio

Learning Objectives

Key Terms

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).

As a percent of earnings

Baby Boomer

The post-WWII generation responsible for a sharp increase in the U.S. population. Their collective activities have a sizeable effect on the market.

dis-saving

The act of cashing in savings and liquidating assets to spend on goods and services.

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 existed in the stock market of the 2010s to offset the influence of Boomer dis-savings on pricing, except for the Federal Reserve’s (the Fed’s) monetary policy reflected in interest rates and bank liquidity. In contrast, during the 2020s , 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 feel downward pressure while speculators decline in numbers during the upcoming years as a result of their own self-destructive practices in *momentum markets*. [See Figure 1]

P/E ratios and multipliers for a fast read

price-to-earnings (P/E) ratio

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.

net income multiplier (NIM)

The property’s price as a multiple of the net operating income.

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.

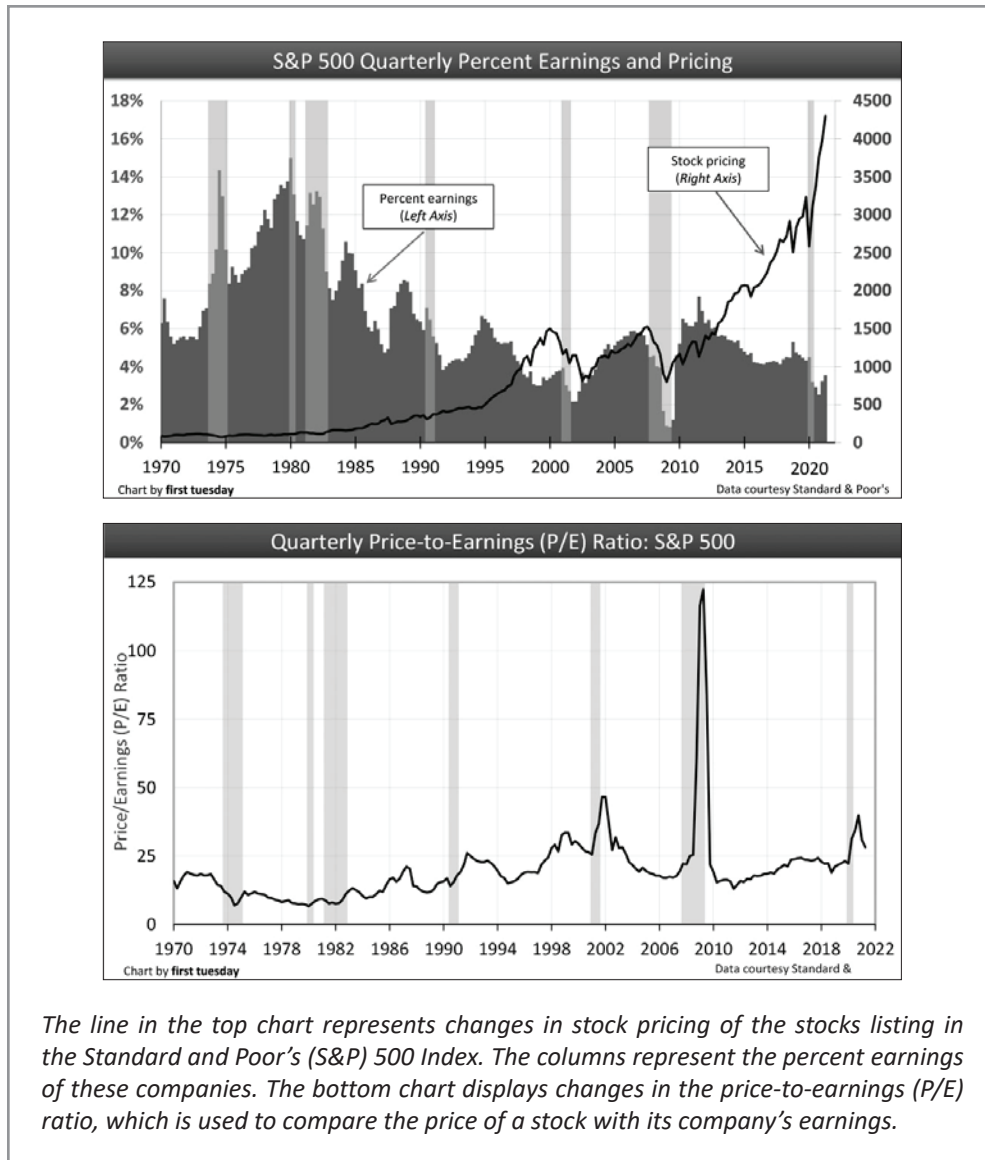


Figure 1

S&P 500
Quarterly
Percent Earning
and Pricing

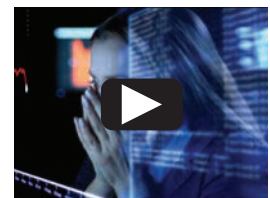
and

Quarterly Price-
to-Earnings
(P/E) Ratio: S&P
500



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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 remained at more realistic levels through 2019, though still slightly higher than the historically applicable average of 16, in a range of 10 to 20, a 6% return on investment. As of Q2 2021, the P/E ratio was a much higher 28.2, equivalent to an uninspiring cap rate of just 3.5%.

This return to market norms in 2009 and early 2010 came about due to a combination of gradually rising stock prices and dramatically rising earnings. Provided the market continues to gradually right itself, investors will soon become more tolerant of risk, and the economy as a whole will benefit.

A difference in who manages your investment

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.

However, the effects of the **2020 recession** began to shake up the stock market beginning in Q1 2020 when stock prices dropped sharply. Even as the impacts of the 2020 recession continued throughout 2021, in the form of 1.3 million jobs still missing in California as of July 2021, stock prices continued to rise to new heights, evidence that the market is detached from the economic reality. Once stocks return to standard market norms, investors will adjust to the coming reality of the rise in interest rates over the next two-three decades as U. S. GDP increases. Investments will reflect this realization, keeping the P/E ratio between 10 and 20, and percent earnings between 10% and 5%. 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).

The bump in stock prices experienced beginning in 2010 as fueled by speculators did not inject enough fresh money into the system to replace the long-term investments being taken out by the constantly aging Boomer generation.

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

After dramatic drops in the third and fourth quarters of 2009, the P/E ratio has since remained at more realistic levels, at 18.1 in Q4 2018. This is the lowest quarterly P/E ratio experienced since 2013, 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.

Baby Boomer	pg. 206
capitalization rate (cap rate)	pg. 208
dis-saving	pg. 206
net income multiplier (NIM)	pg. 206
price-to-earnings (P/E) ratio	pg. 206

Chapter 13.1 Summary

Chapter 13.1 Key Terms

Chapter 13.2

REIT investments as stocks

Learning Objectives

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.

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.

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)?

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.

Property owning corporations

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.

Federal tax reporting qualification

Restricted management ability

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

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.

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

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.

Methods of ownership

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.

shareowners

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.

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 rebound and regain shareholder value following a steep drop in all stock prices in the first half of 2020. While the general trend is up, REITs occasionally will fluctuate in the coming years when vacancies rise and more business failures occur. [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.

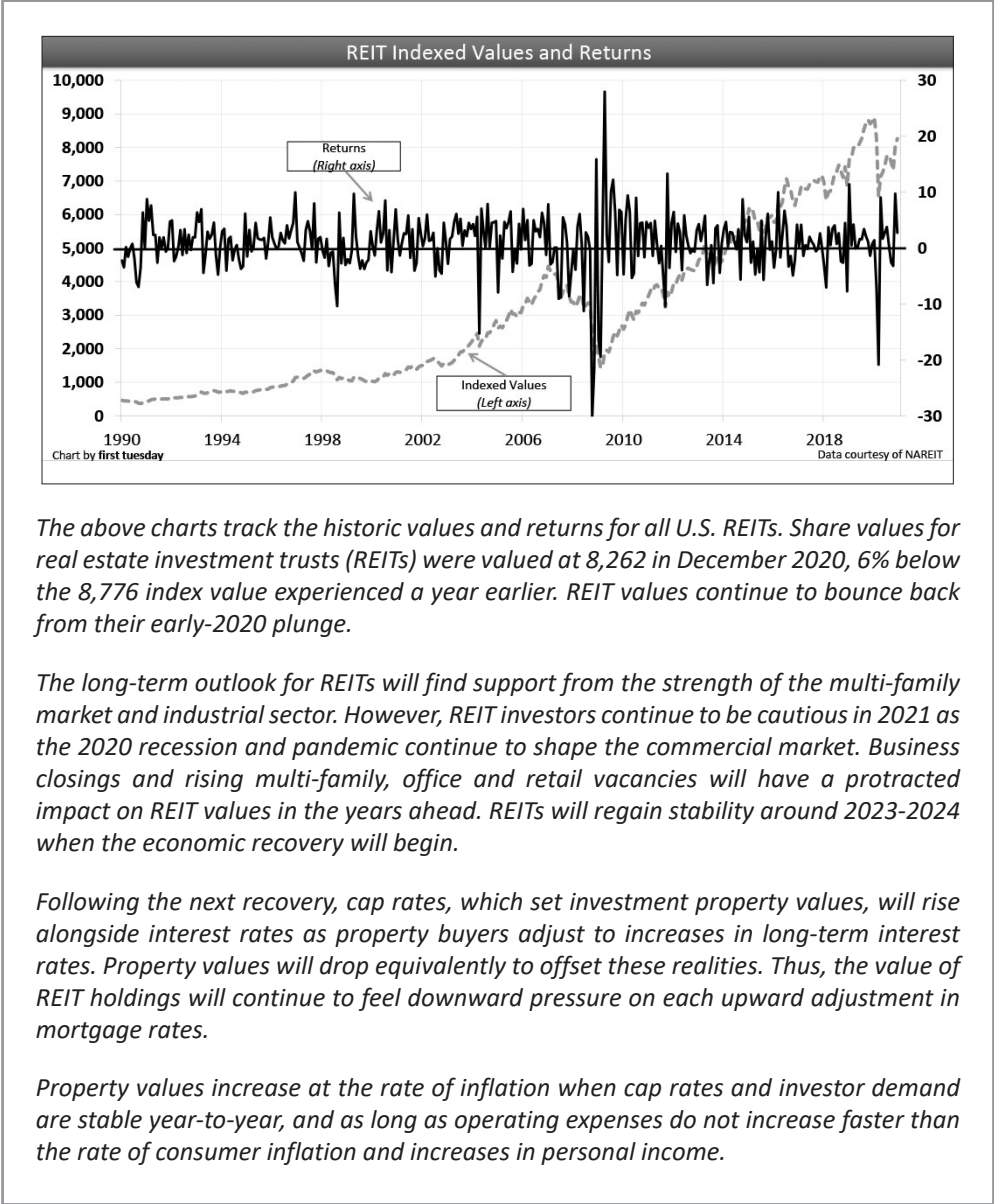
However, at this time not all sectors of the commercial real estate market have recovered from the recession.

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.

Investment fundamentals

Figure 2
REIT Indexed Values and Returns


ONLINE UPDATE
Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



The above charts track the historic values and returns for all U.S. REITs. Share values for real estate investment trusts (REITs) were valued at 8,262 in December 2020, 6% below the 8,776 index value experienced a year earlier. REIT values continue to bounce back from their early-2020 plunge.

The long-term outlook for REITs will find support from the strength of the multi-family market and industrial sector. However, REIT investors continue to be cautious in 2021 as the 2020 recession and pandemic continue to shape the commercial market. Business closings and rising multi-family, office and retail vacancies will have a protracted impact on REIT values in the years ahead. REITs will regain stability around 2023-2024 when the economic recovery will begin.

Following the next recovery, cap rates, which set investment property values, will rise alongside interest rates 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 feel downward pressure on each upward adjustment in mortgage 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.

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 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.

Investment today

A noticeable sales volume slump in the commercial real estate sector occurred in 2020, with all property types but industrial impacted. At the same time, the drop in mortgage rates which began in late-2017 continued to fuel rising property prices.

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

Further research before investing in REITs

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.

Chapter 13.2 Summary

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.

limited liability company (LLC) pg. 211
real estate investment trust (REIT) pg. 210
shareowners pg. 212

Chapter 13.2

Key Terms

Chapter 13.3

Investing: stocks or real estate?

Learning Objectives

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

Stocks: the more volatile choice

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 the first quarter (Q1) of 2020, stock prices fell from previously unprecedented heights as investors fled the market in a pandemic-induced panic. However, despite the 2020 recession, stocks bounced back quickly in 2020 and are once again at historic highs going into 2021.

Like real estate pricing, stocks cannot rise indefinitely. When next they 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.

Stock prices: a history of speculation and downfall

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

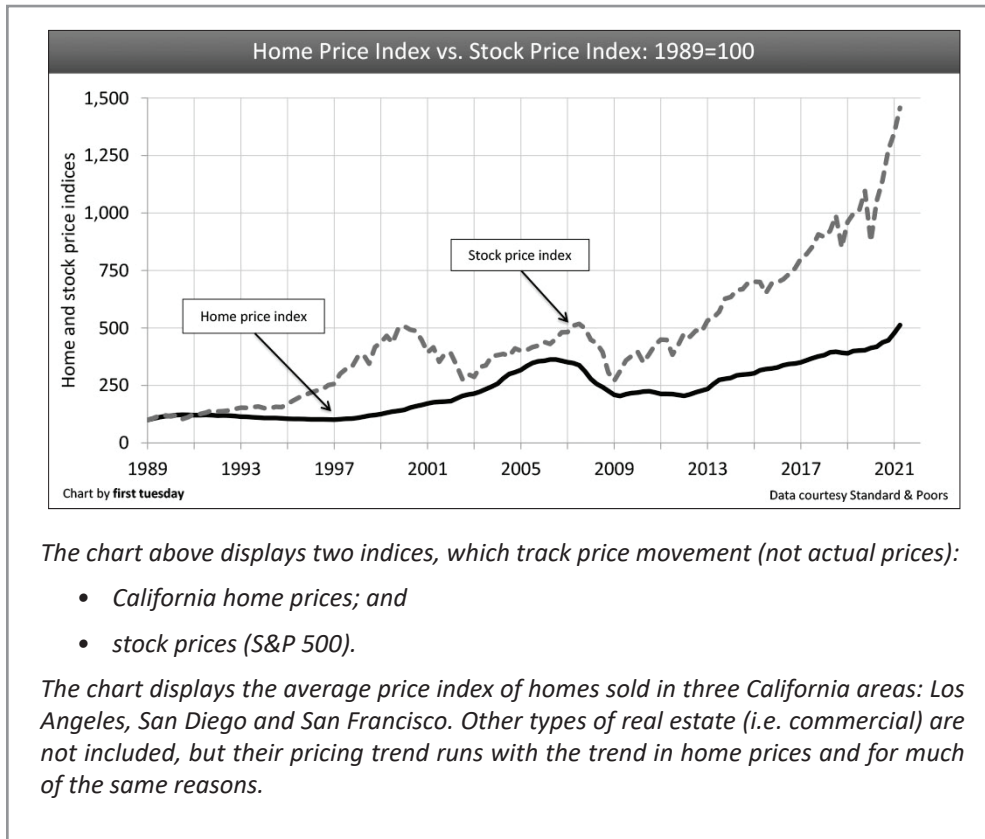
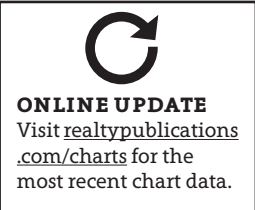


Figure 3

Home Price Index vs. Stock Price Index: 1989=100



[Click to watch](#)

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 continued to rise

through the start of 2020 for the same reason, despite a brief dip in early 2016. However, the good times came to an end with the Fed-induced short-term interest rate hikes, which began to cool the economy in 2018. Stock prices peaked a short time later, in February 2020.

The most recent commodities bubble trouble isn't due entirely to 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 in 2021.

Real estate: the choice for greater stability

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 8: 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.

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.

**Real estate
— it runs
with inflation
and incomes!**

**California's
low cap rates
spell trouble
for SFR
investors**

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.

The future movement of cap rates

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**.

property appreciation

The portion of the increase in property prices beyond the rate of inflation.

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 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.

property appreciation pg. 238

Chapter 13.3 Summary

Chapter 13.3 Key Term

Notes:

Factor 14: Retirees



Boomers retire and California trembles



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.

Baby Boomer

dis-saving

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.

Chapter 14.1

Learning Objectives

Key Terms

**Retirees will
move real
estate, lots
of it**

California population aged 65+

Baby Boomer

The post-WWII generation responsible for a sharp increase in the U.S. population. Their collective activities have a sizeable effect on the market.

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 2019 over the prior year — traditionally comprises the retired and soon-to-be retired.

From 1995 through the early 2000s, 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 has already started 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 2008 recession briefly delayed the 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 were not cancelled, but merely delayed. Now that the stock market has rebounded and home prices have bounced back completely in all regions of California, retirees have gradually regained most of their pre-recession confidence and perhaps some of their old spending habits.

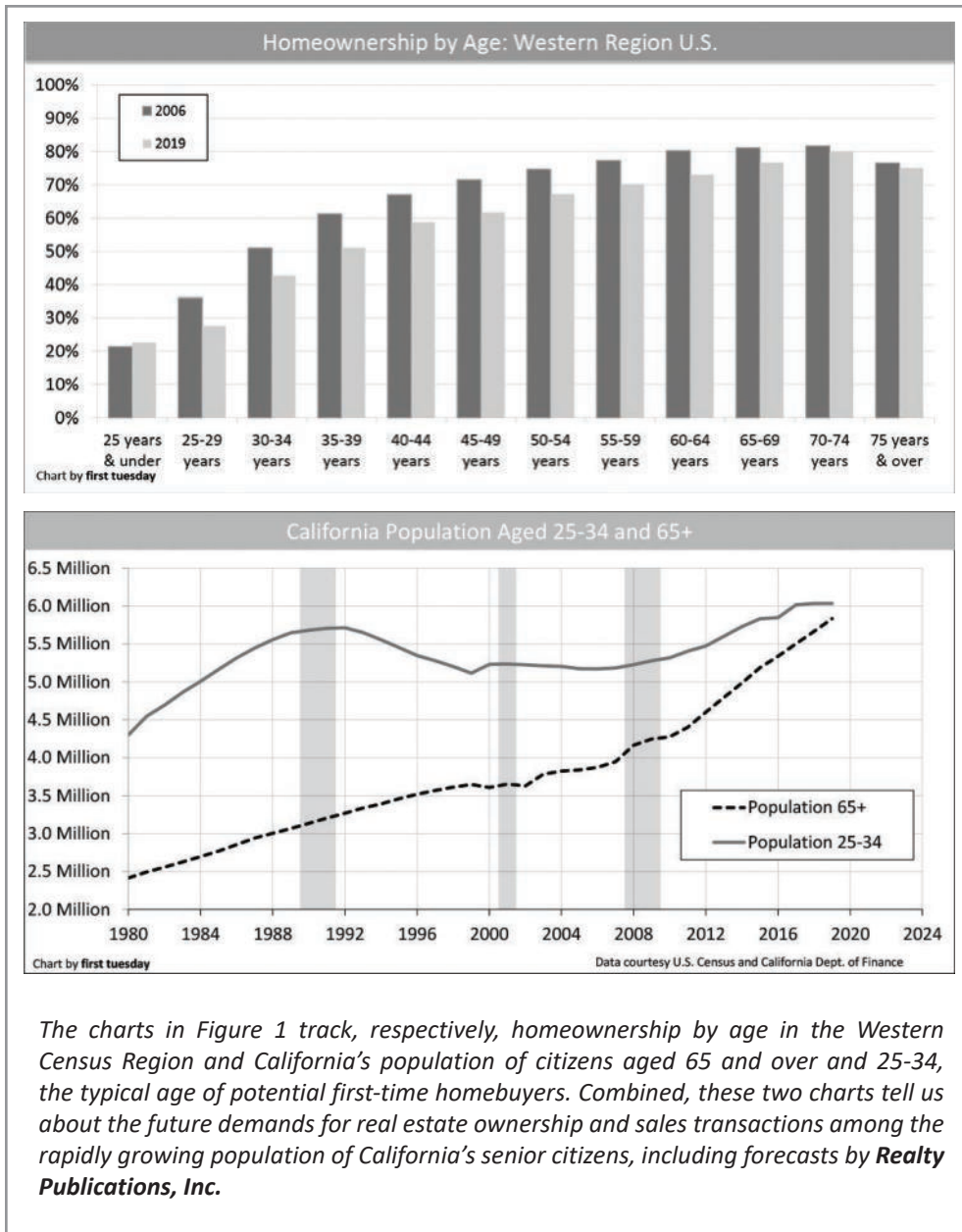


Figure 1
Homeownership by Age: Western Region U.S.
and
California Population Aged 25-34 and 65+

ONLINE UPDATE
Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.

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.

dis-saving
The act of cashing in savings and liquidating assets to spend on goods and services to maintain a lifestyle.

Property prices increased rapidly through 2013 and slowed to a level increase of 8%-10% annually in 2014-2017. Home price increases fell back in 2018-2019, increasing closer to 5% annually before jumping in 2020 due primarily to record-low interest rates. As sales volume continues to slow and the building serious delinquencies become the next wave of foreclosures, home values are

expected to reverse direction later in 2021. Once prices bottom, likely around 2023, 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 limited housing stock.

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

History repeats itself for the Boomer

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.

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.

¹ Calif. Revenue & Taxation Code §69.5

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 in the mid- to late-2020s.

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.

Baby Boomer pg. 226
dis-saving..... pg. 227

Post-2020 retirement

Chapter 14.1 Summary

Chapter 14.1 Key Terms

Chapter 14.2

Downsizing and relocating: the traditional retiree pastime

Learning Objectives

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.

Key Terms

casita/granny flat

senior citizen

Great Confluence

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 2020 United Van Lines survey, 30% of older residents are choosing to move out of state. 23% of survey respondents who moved out of California cited retirement as the main reason, while only 8% 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 2020:

- in the 18-34 age group, 23% moved into the state, while 12% moved out of the state;
- in the 35-44 age group, 23% moved into the state, while 17% moved out of the state;
- in the 45-54 age group, 15% moved into the state, while 16% moved out of the state;
- in the 55 to 64 age group, 20% moved into the state, while 26% moved out of the state; and
- in the 65 and older age group, 19% moved into the state, while 30% moved out of the state.

These trends have accelerated in recent years, with older residents leaving at a higher rate in 2020 than in years past.

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

Retiring out of state

senior

An individual over the age of 65.

casitas / granny flat

Attached, freestanding, or over-the-garage apartments that have no direct access to the main house.

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.

Seniors' ownership favors brokers and agents

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.

The Great Confluence

There will be a solid return of buyers-occupants to the housing market around 2023, likely peaking in 2024-2025. Younger members of Gen Y and older Gen Z-ers, both larger demographics 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.

Great Confluence

The convergence of retiring Baby Boomers and Generation Y on the same urban real estate.

Retirees tend to stay owners in retirement. However, this does not mean they will stay in their original homes. Many will desire to be closer to family or pursue a better climate. Senior housing will be the most directly affected by the coming Boomer retirements.

Also on the rise are home additions of casitas or granny flats. These are attached, freestanding, or over-the-garage apartments that have no access to the main house, effectively converting SFR zoned property to a duplex.

The relocation of Boomers will be a boon for brokers and agents. Half of senior relocations are within the same community. Alternatively, some will emigrate out of state or out of the country.

casitas/granny flat..... **pg. 232**
Great Confluence **pg. 233**
senior **pg. 231**

**Chapter 14.2
 Summary**

**Chapter 14.2
 Key Terms**

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

<p>buy-to-let investment</p> <p>diversification</p> <p>opportunity cost</p>	<p>risk tolerance</p> <p>syndication</p>
--	--

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.

risk tolerance
The amount of investment risk an investor is willing to accept.

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 2020-2025 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

Dis-savings

Shifting to long-term real estate investment

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

opportunity cost
The cost of an action forgone when choosing to take an alternative action.

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 6: 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.

The huge losses experienced during the past decade or so of financial crisis, housing bust, 2008 recession and elongated recovery have 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**.

buy-to-let investment
Long-term income property investment.

When the cycle favors sellers

syndication
When a group of investors form a limited liability company to fund the purchase price and carrying costs of owning real estate.

Syndication: market smarts and money sources

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.

Diversification: the name of the game

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.

diversification

Varying the types and areas of investment in a portfolio to mitigate risk.

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.

Chapter 14.3 Summary

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.

buy-to-let investment	pg. 237
diversification	pg. 238
opportunity cost	pg. 236
risk tolerance	pg. 235
syndication	pg. 237

Chapter 14.3

Key Terms

Notes:

Factor 15: First-time homebuyers



Household formations and sales volume trends



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.

absorption rate

zero ability to pay (ZAP)

household formation

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.

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


Chapter 15.1

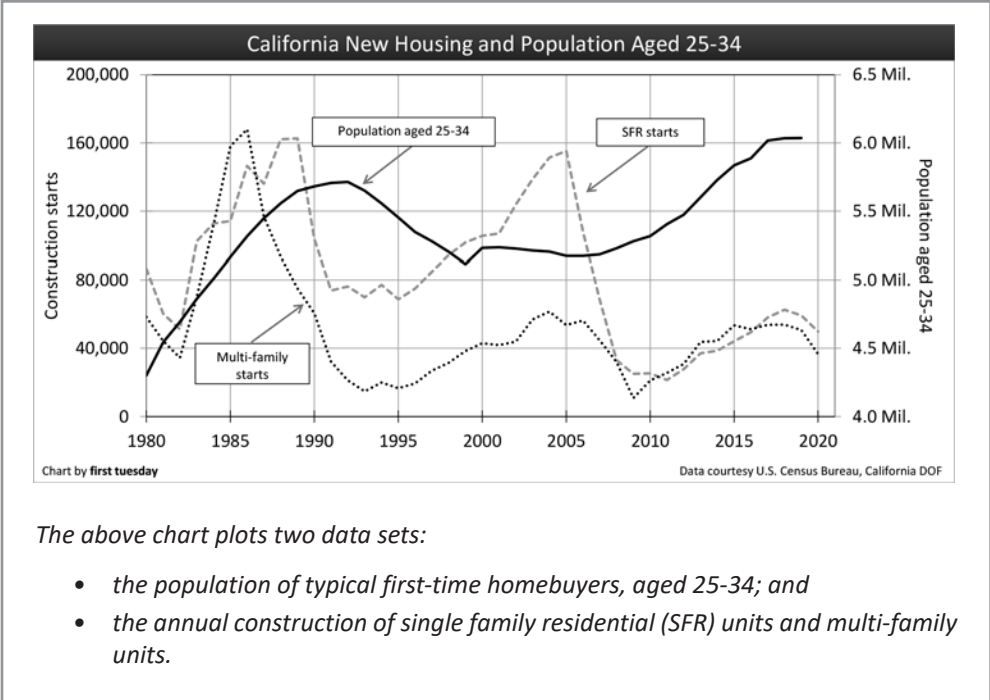
Learning Objectives

Key Terms

California new housing and population aged 25-34

Figure 1
California New Housing and Population Aged 25-34


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



- 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]

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.

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-time homebuyer age group will not start supporting and enlarging current home sales volume levels until around 2024-2025, when the now financially mature age group will finally be willing to enter the housing market in large numbers.

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 during the foreclosure crisis and elongated recovery from the 2008 recession in California. Foreclosures hit their bottom in 2014-2016. The home price increases experienced in 2012-2020 have lifted all of the state's previously negative equity properties above water. Looking forward, foreclosure numbers will rise again, and rapidly, once the foreclosure moratorium of 2020-2021 expires. A significant 4.8% of California mortgaged homeowners have a serious delinquency going into 2021, and without a return of the jobs lost during the 2020 recession, these homeowners are heading for foreclosure.

While many negative equity homes will be foreclosed upon, others will go to short sales and into REO inventory or the speculator 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. Looking ahead, expect a similar increase in speculator presence once prices hit bottom here in California — expected around 2022-2023. 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.

The desire to own one's housing

zero ability to pay (ZAP)

The household financial situation where a mortgage debt commitment when coupled with other necessities exceeds disposable income.

A bumpy road ahead

1.5% of mortgaged homes remain underwater in California in the third quarter (Q3) of 2020, down from 2.1% a year earlier. California now has the fewest **underwater** properties since the Millennium Boom. However, 2020's rapid home value increase coincided directly with the historic drop in interest rates, set in place by the Federal Reserve (the Fed) to boost borrowing during the 2020 recession. Now that interest rates have bottomed and jobs remain far, far away from recovery, support for home values — and the low negative equity share — is waning quickly.

household formation

Individuals who acquire their own property, such as adult children leaving parents' households or singles leaving shared housing.

Once home prices do bottom — expected around 2022-2023 — Gen Y and Gen Z homebuyers will drive the market. Previous upticks in Gen Y **household formations** had increased rental demand, triggering a jump in multifamily/apartment starts. This time, new single family residential (SFR) starts will occur as tenants shift to homeownership — leaving periphery apartments vacant.

All of this action in the early 2020s 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

Chapter 15.1 Summary

While just 1.5% of mortgaged homes are stuck in a negative equity position in California going into 2021, forces will push this share higher over the next couple of years. These factors include the historic job losses of 2020, high 90+ day delinquency rates and declining sales volume. Going into the 2020 recession, members of Generation Y (Gen Y) — in small part compared to their Boomer parents — had sufficient income to have saved some money for a minimum down payment and are willing to take on homeownership and mortgage debt. However, this momentum has met obstacles in the form of low inventory and now the uncertainties of another major recession.

Once jobs return and the coming foreclosures are purged from the market, expect an uptick in Gen Z household formations, which will initially increase rental demand. Their demand will trigger a jump in multi-family/apartment starts which will peak in 2024-2025. 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.

Chapter 15.1 Key Terms

absorption rate pg. 242
household formation pg. 244
zero ability to pay (ZAP) pg. 243

Homeownership declines among the young

Chapter 15.2

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

Learning Objectives

Key Terms

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 homeownership rate had dropped to 36%. This share hit another peak of 43% at the height of the Millennium Boom. 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

Restless, relocating with job opportunities

designed to encourage ownership. In 2019, the homeownership rate for this same age group (now consisting of those born in the 1990s) had fallen back to 35%.

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.

Why has homeownership fallen among the young?

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.

The Boomers experienced, their children learned

From 2007-2017, roughly one million California families (out of the approximately 8.1 million single family residential units (SFRs) statewide with 7 million owner-occupied as of 2017) have lost their homes to foreclosure.

Many, burned financially and emotionally by the loss of their home, will not return to homeownership. 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 and older members of Gen Z begins buying their first homes en masse. This phenomenon will peak around 2024-2025, as Gen Y finally sees an opportunity to become homeowners once prices bottom following the next recession. 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 next housing boom does begin to develop later this decade, it may be weaker than optimists expect. The future will reward those with an eye for sales and management of upper mid- and high-tier properties. California's legislature has already focused its efforts on adding to the low- and mid-tier rental inventory in recent years. But 2019 and 2020 both saw multi-family construction decrease, a sign that more government change is needed to fulfill demand from these younger generations.

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

**The future of
real estate
services**

**Back to
school – more
training, debt
and delay**

cramdown

The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.

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 particularly damning 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.

Purchases delayed for indebted college graduates

In their pursuit of higher education, Gen Y and now Gen Z have raked 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 a **Federal Housing Administration (FHA)-insured mortgage**. 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.

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 (LTV) ratio and high mortgage insurance premiums (MIPs), typically made to first-time homebuyers.

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 2018 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 Isaac 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 and Gen Z'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.

Rising education debt hampers future homeownership

Debit-anxiety tolerance in Gen Y

Slouching towards the altar: household formations

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, once home prices match their hard-earned (and long-awaited) incomes. This will likely occur in the period following 2021, during which a real estate mini-boom will develop.

The urban vogue

When Gen Y and Gen Z does eventually start buying, where will they go?

Gen Y and Gen Z, equipped with higher education and (eventually) more stable incomes, will increasingly 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 their employment income matches up with home prices, expected following the recovery from the 2020 recession, likely to begin around 2023.

Agents anticipating the coming tide of Gen Y and older Gen Z 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 their practice and operating their real estate practice in the urban areas of their communities that will likely experience the most action heading into 2023 and beyond.

Reflective of status

Gen Y will trigger an avalanche of homebuying

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 the early 2020s.

Chapter 15.2 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 15.2 Key Terms

cramdown	pg. 248
Federal Housing Administration-insured mortgage	pg. 248

Gen Y and Gen Z incomes and the implications for home prices

Chapter 15.3

After reading this chapter, you will be able to:

- analyze how Gen Y's and Gen Z's future income expectations will impact future home prices.

mean price trendline

Learning Objectives

Key Term

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. While 2020 statistics are not yet available, the average per capita incomes likely also dropped during 2020 due to the severe job losses. 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

Lower incomes for Gen Y

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]

Gen Y's tortured entry into the workforce

Flash forward to 2019. 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, and often taking on multiple forms of employment. But these less stable, 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, 35% of the population had a bachelor's degree or higher as of 2019, 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.

Lower income = less saving

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 remained low in the decade following the 2008 recession, casting doubt on the ability of most first-time homebuyers to muster a full 20% down payment. While the personal savings rate jumped to historical levels in 2020, this was due to stimulus interference and caution from individual households amidst the pandemic. [See Factor 23: Pandemic]

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 have caused 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 remain low. Homeownership rates will suffer until Gen Y and Gen Z finally gain enough income and savings to make their foray into homeownership, likely to occur around 2024. However, the homeownership rate here will still remain consistently lower than the national average.

Going into 2021, home prices are unstably high following years of steadily rising beyond the rate of incomes. However, with interest rates unable to go lower and the end of the foreclosure moratorium on the horizon, home prices are forecasted to fall in 2021-2022. Taking future incomes and savings into account, we know this reduction in home prices is just what Gen Y needs to enable a higher homeownership rate in the years ahead.

The support real estate sales volume needs from end users (those buyer-occupants and buy-to-let investors) is simply not there in 2021. Jobs and incomes continue to recover — slowly — and buyer purchasing power will be inhibited in the coming years as interest rates cannot go lower than their present historic lows.

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 2021 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]

Today's prices, tomorrow's downfall

mean price trendline

A reflection of consumer inflation and changes in local demographics of density and income to which property prices cyclically return.

Agents, beware of stagnation!

Chapter 15.3 Summary

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.

Today's would-be first-time homebuyer generation, Generation Y (Gen Y) and older members of Gen Z, 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.

Both of these realities will cause Gen Y and Gen Z to delay the purchase of a home for several years, past the expected typical first-time homebuyer age range of 25-34 years.

Chapter 15.3 Key Term

mean price trendlinepg. 255

Factor 16: Fiscal spending



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

Chapter 16.1

After reading this chapter, you will be able to:

- decipher the monetary policy events behind the severity of the severe real estate downturn following the Millennium Boom;
- observe California's unfinished recovery from the foreclosure crisis; and
- recognize the Golden State's promising future.

adjustable rate mortgage (ARM)

American Dream policy

competitive advantage

Federal Reserve

subsidy

vicious economic cycle

Learning Objectives

Key Terms

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.

When the financial levies broke

Federal Reserve

The central bank in control of regulating the U.S. monetary system and charged with maintaining proper employment levels and managing inflation.

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.

Government pours fuel on the fire

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

adjustable rate mortgage (ARM)

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]

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 6: 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.

Government push for ownership: a one-sided discussion

Mortgage fundamentals vs. the American Dream

American Dream policy

The government's push to increase the homeownership rate from the historical 64% to 70%.

Financial cause and effect: time to pay the piper

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.

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 2.3% of mortgaged homes underwater, down from 3.2% a year earlier.

It hurts to reset your ARM

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.

In 2021, home sales volume has increased from a year earlier following over a year of historically low interest rates. Prices have also felt the boost from low interest rates, over 20% higher than a year earlier going into 2022. But interest rates have now rebounded from their bottom, and continue to rise in late-2021. Looking ahead to a future of consistently rising interest rates,

competitive advantage

Increasingly drastic measures motivated by the desire for ever greater earnings and strategic advantage over one's rivals.

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]

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.

Thus, the recovery never fully realized, with real estate sales volume remaining stuck through 2020, peaking during the never-ending recovery in 2017 at a level just 61% of the annual Millennium Boom peak.

Thus, when the next recession arrived in February 2020, home sales volume was still circling the drain. However, unsustainable price increases continued to occur, fueled by plunging interest rates and a strangled multiple listing service (MLS) inventory, thus giving the illusion of a healthy housing market, despite the recession.

In 2021-2022, look to the Fed as the only player to keep interest rates near the historic lows of 2020. FRM rates have already begun to creep up, immediately

Déjà vu for builders, lenders and brokers

vicious economic cycle

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.

subsidy

The government support of a particular entity or activity. For homebuyers, these come in the form of tax credits.

stifling buyer purchasing power and enthusiasm. The Fed may accomplish this goal by continuing its purchase of mortgage-backed bonds (MBB's), as it refuses to drop its zero-bound benchmark interest rate further, but the Fed has already signaled a coming bond taper heading into 2022. Thus, the rate rise is inevitable. [See Factor 17: Monetary policy]

**Chapter 16.1
Summary**

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.

**Chapter 16.1
Key Terms**

adjustable rate mortgage (ARM) pg. 258
American Dream policy pg. 259
competitive advantage pg. 260
Federal Reserve pg. 258
subsidy pg. 261
vicious economic cycle pg. 261

Factor 17: Monetary policy



The lender of last resort

Chapter 17.1

After reading this chapter, you will be able to:

- discuss the history, purpose and function of the Federal Reserve (the Fed) as the nation's central bank; and
- understand how the Fed's monetary policies sustain the U.S. economy.

beige book

Continental

easy money

**Federal Open Market
Committee (FOMC)**

**Federal Reserve Board of
Governors**

Federal Reserve District Bank

Free Banking Era

tranches

Treasury Bills (T-Bills)

Learning Objectives

Key Terms

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

The policies and functions of the Federal Reserve

setters 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.

Banking before there was a Fed

Continental

An early form of currency issued by congress after the start of the Revolutionary War.

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.

First banks of the United States

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 chartered 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.

Return to chaotic banking

Free Banking Era

1837-1862. No central banking system existed during this time. States chartered their own banks and held their own reserves.

The Fed emerges as the bankers' bank

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 structure of the central banks

Federal Reserve District Bank

The 12 branches of the “central” bank.

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* Boston;
- *Second district* New York;
- *Third district* Philadelphia;
- *Fourth district* Cleveland
- *Fifth district* Richmond;
- *Sixth district* Atlanta;
- *Seventh district* Chicago;
- *Eighth district* St. Louis;
- *Ninth district* Minneapolis;
- *Tenth district* Kansas City;
- *Eleventh district* Dallas; and
- *Twelfth district* 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 in 2019 is Mary C. Daly.

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.

Limited independence

Board of governors

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 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.

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.

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.

The promotion of borrowing

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.

easy money

When there is too much cash in circulation causing excessive inflation, rectified by the Federal Reserve increasing short-term interest rates.

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)**.

Who funds the operations of the Fed?

Other roles of the Fed

Treasury Bills (T-Bills)

Government securitized debt instruments. T-bills are sold to the public, member banks and other financial institutions.

The government's lender from within

tranches

Bonds issued by investment pools divided into various levels of risk, reward and rate of maturity.

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.

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.

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Chapter 17.1 Key Terms

beige book	pg. 268
Continental	pg. 264
easy money	pg. 268
Federal Open Market Committee (FOMC)	pg. 267
Federal Reserve Board of Governors	pg. 267
Federal Reserve District Bank	pg. 266
Free Banking Era	pg. 265
tranches	pg. 269
Treasury Bills (T-Bills)	pg. 269

Factor 18: Politics



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.

John Maynard Keynes

rentier

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 (MBS)** investments. Designed for public consumption by investors, MBSs are comprised of:

- *residential mortgage-backed securities (RMBS)*;
- *collateralized debt obligation (CDO) securities*; and
- *credit default swaps (CDS)*.

Chapter 18.1

Learning Objectives

Key Terms

The world of passive entitlement

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.

Prolonged suffering

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. In a word: customary.

rentier

The class of earners whose income is earned passively, generated from owned tangible and intangible assets rather than through their labor.

Different laws for different social classes

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 the long recovery from the 2008 recession, the Fed consistently lent money to banks at essentially zero percent interest rates. In return, the banks were expected, though not required, to increase their own lending to private borrowers. Then, in December 2015, the Fed increased their target rate for the first time since 2009. Since its initial rate bump, the Fed increased their target rate from zero to 2.25-2.50 in 2019. Then, as the 2020 recession rapidly took hold, the Fed returned their benchmark rate to zero, where it currently rests in 2021. The Fed has indicated it will not increase its rate again until 2023 at the earliest. [See Factor 2: Interest rates]

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.

**It's just
corporate
business
strategy**

Who are the rentiers?

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.

Growing together despite our differences

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*.

John Maynard Keynes

An economist well-known for his stance that governments need to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

Conflicting philosophies

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).

Entrenched rentier dominance

Wall Street versus main street

The effect of quantitative easing

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 2005 homeowner bankruptcy rights now only available to property investors — that rentier class distinction again. [See Factor 17: Monetary policy]

A harmful artificial distinction

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.”

**Troubled
assets
obscured**

Chapter 18.1 Summary

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 Key Terms

John Maynard Keynes	pg. 274
rentier	pg. 272

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.

community banks

Fannie Mae

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,

Chapter 18.2

Learning Objectives

Key Terms

America's common enemy

Other lending options exist

community banks
Small and local banks not tied to the "too big to fail" Wall Street 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.

Better luck at local institutions

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.

A far cry from the New Deal

Fannie Mae

A government-sponsored entity operating in the secondary mortgage market.

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 7: 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 downside of MBBs

Introducing the financial accelerator

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.

The financial accelerator in action

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.

Back to fundamentals

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 just above 2% 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.

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.

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 provides **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.

**Underwater
owners begin
to drown**

**Shop around
for the best
deal**

Form 312
Mortgage Shopping Worksheet

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. <i>Items left blank or unchecked are not applicable.</i>				
Lender 1:	Lender 2:	Lender 3:		
Lender: _____	Lender: _____	Lender: _____		
Loan Officer: _____	Loan Officer: _____	Loan Officer: _____		
Date of Contact: _____, 20____	Date of Contact: _____, 20____	Date of Contact: _____, 20____		
	Lender 1:	Lender 2:	Lender 3:	Current Mortgage:
Total mortgage amount				
Down payment				
Mortgage term (years)				
Total monthly payment to lender				
If taxes and insurance (TI) are not included in the monthly payment, what is the additional monthly TI amount?				
If private mortgage insurance (PMI) or mortgage insurance premiums (MIPs) are required, what is the monthly cost?				
If PMI/MIP is included, when may it be cancelled?				
<input type="checkbox"/> Fixed rate mortgage (FRM): [See RPI Form 320]	<input type="checkbox"/> Conventional, <input type="checkbox"/> FHA, <input type="checkbox"/> VA, <input type="checkbox"/> Jumbo.	<input type="checkbox"/> Conventional, <input type="checkbox"/> FHA, <input type="checkbox"/> VA, <input type="checkbox"/> Jumbo.	<input type="checkbox"/> Conventional, <input type="checkbox"/> FHA, <input type="checkbox"/> VA, <input type="checkbox"/> Jumbo.	<input type="checkbox"/> Conventional, <input type="checkbox"/> FHA, <input type="checkbox"/> VA, <input type="checkbox"/> Jumbo.
Interest rate	%	%	%	%
<input type="checkbox"/> Adjustable rate mortgage (ARM): [See RPI Form 320-1]	Initial rate	Initial rate	Initial rate	Initial rate
When is the first interest rate adjustment?				
How often does the rate change?				
Interest rate adjustment floor/cap				
Rate index name				
Lender's margin	%	%	%	%
Lender fees for processing the mortgage				
Origination / points charged				
Appraisal fee charged				
Other fees				
If there is a final/balloon payment, when is it due and in what amount?				
If there is a prepayment penalty, what is the amount?				
Date Prepared: _____, 20____				
Prepared by: _____ Prepared for: _____				
FORM 312 03-15 ©2016 RPI — Realty Publications, Inc., P.O. BOX 5707, RIVERSIDE, CA 92517				

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.

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 (MBSs) 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.

community banks pg. 279
Fannie Mae pg. 280

**Live within
your means,
dear buyer**

**Chapter 18.2
Summary**

**Chapter 18.2
Key Terms**

Notes:

Factor 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.

exchange rate

gross domestic product (GDP)

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 fifth largest GDP in the world, below Germany and just above the United Kingdom.

How does California *real estate* fit into this global puzzle?

Chapter 19.1

Learning Objectives

Key Terms

Global forces make themselves at home

gross domestic product (GDP)

The market value of all goods and services produced within a country calculated over a set period of time.

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, 19% of real estate agents surveyed by the National Association of Realtors (NAR) assisted in home sales with international buyers and sellers in 2020. This share has steadily declined from its 2015 peak, when 35% of survey respondents assisted an international client.

The survey also showed:

- the amount of money spent on homes by international buyers was 5% lower in 2020 than 2019, amounting to a decrease of about \$4 billion;
- the majority of international investors are from China, followed by Canada, the U.K. and Mexico; and
- 61% of international buyers who purchased during 2020 were U.S. residents (though not necessarily citizens).

Some of these buyers plan to use their purchase as a vacation home, while others will use it primarily as an investment property. 68% of international buyers who lived in the U.S. at the time of purchase bought their home for their primary residence.

In California, 54% of international buyers were from Asia, with California receiving more real estate purchasers from China and India than any other state.

Why do foreign investors like California real estate?

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 161,700 international students here as of 2018. 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** fluctuates compared to other nations' currencies, with the dollar's value considered to be more stable when viewed through the lens of less stable economies like Mexico, Canada, China or the European Union, etc.

On the flip side, a stronger dollar (essentially a more expensive dollar to international clients) reduces the **buyer purchasing power** of international homebuyers. This results in a decline in international buyers across the U.S., as buyers wishing to pay with all cash find their cash unable to purchase as much property.

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 when interest rates begin to rise again consistently, anticipated to begin in 2023. [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 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.

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 foreign investors good or bad for today's real estate market?

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 unstable real estate market, when owner-occupant homebuyers are fighting against an inventory shortage and high prices (though prices are expected to fall with the expiration of the foreclosure moratorium later in 2021). At the start of 2021, California is still missing 1.35 million jobs from before the 2020 recession and each of these jobs lost represents lost or reduced income for households already struggling to keep up with California's expensive housing and rental market. 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.

Foreign instability

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 dropped the short-term interest rate to essentially zero in 2020 in an effort to stimulate lending, and in turn encourage job creation and wage growth. This has allowed mortgage rates to remain low, enticing homebuyers to purchase. The Fed has announced its intention to keep its short-term rate low until around 2023, when it will begin to raise the short-term rate. In the long recovery from the 2008 recession, the Fed has been careful to increase interest rates as the economy is ready, as the results from raising rates too fast will be further economic stagnation (and an even worse flattening of volume and prices in the real estate market).

Trade war impacts

All of this action is complicated by the trade war the past U.S. administration pushed against several nations which typically send high investment money to California, including Canada, China and Mexico.

Some of the steps the administration has taken in this trade war which directly harm real estate include the:

- 25% tariff on imported steel;
- 10% tariff on imported aluminum;
- 20% tariff on Canadian softwood lumber;
- 30% tax on imported solar panels and solar energy cells; and
- 20%-50% tariff on imported washing machines.

The goal of the administration was to make foreign government and companies cut their costs, but the actual result is that companies and consumers in the U.S. have been paying more to purchase these materials and products. In particular, these tariffs have caused the cost of new home construction to rise here in California, a cost that is inevitably passed along to homebuyers of all backgrounds.

The trade war is making buying and maintaining a home more expensive that it needs to be. It also sends a message loud and clear to foreign investors that they are unwelcome in the U.S., a message that is not in line with California’s typically open attitude toward foreign investors.

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 trade war between the U.S. and other global economies is harming California’s real estate market. In particular, the construction industry is feeling the impacts from several tariffs on construction materials.

exchange rate..... pg. 289
gross domestic product (GDP)..... pg. 288

Chapter 19.1 Summary

Chapter 19.1 Key Terms

Chapter 19.2

The Federal Reserve's impact on mortgage rates

Learning Objectives

After reading this chapter, you will be able to:

- identify the importance of the Federal Reserve's (the Fed's) benchmark short-term rate, the Federal Funds rate; and
- understand the Fed's influence on mortgage rates.

The Fed's toolbox contains interest rates

The Federal Reserve's (the Fed's) goals are to maintain:

- stable prices;
- maximum employment; and
- moderate long-term interest rates.

The Fed's main tool to control wages and inflation in the economy has long been the **Federal Funds rate**. This is the rate charged on overnight funds lent to banks by the Fed. In turn, banks lend short-term funds to businesses and consumers to finance purchases of goods and services.

When the Federal Funds rate, known colloquially as the short-term rate, increases, banks are discouraged from borrowing as their **cost of borrowing** from the Fed increases. When the Fed Funds rate falls, banks are motivated to borrow since Fed funds are less expensive. In turn, banks tend to lend with greater or lesser frequency to businesses and individuals based on the lower or higher rates.

Long-term rate movement reflects bond market investor perception about the level of success the Fed rate will achieve fighting inflation (or deflation) in wages and consumer goods and services. When the Fed's inflation fight becomes aggressive, the long-term bond rates decline as investors pile back into bonds.

Recessions coincide with decreases in the Fed Funds rate. Specifically, when the economy enters a recessionary period, the Fed decreases their benchmark rate, making funds cheaper to borrow for banks and in turn consumers. This injects stability into the economy and lessens the depth of a recession.

Following a recession and entering into the recovery portion of a business cycle, the Fed gradually increases the Federal Funds rate. This rate increase is

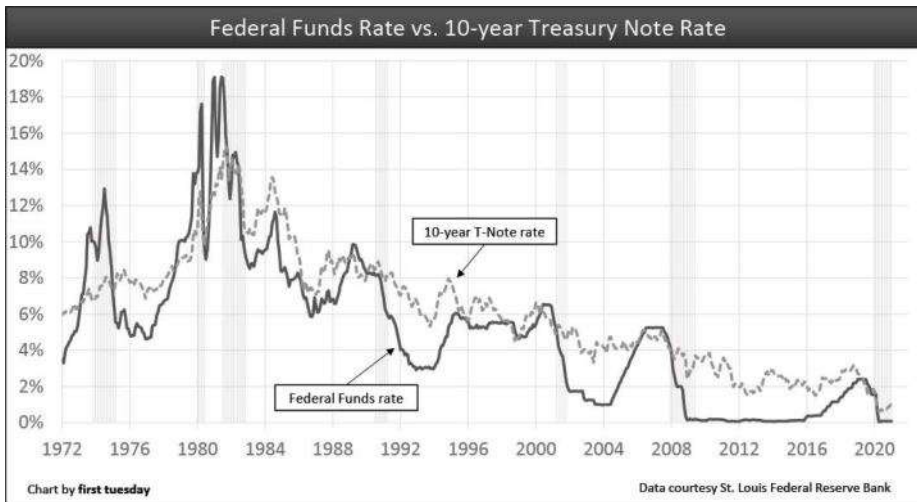


Figure 1

Federal Funds Rates vs. 10-year Treasury Note Rate



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

the Fed's attempt to maintain a lid on the boiling pot to avoid an over-heated economy — evidenced by rapidly increasing asset prices and consumer inflation.

If the pot boils over into economic excess, the recession that follows is long and hard — as most recently experienced in the Great Recession of 2008. That recession and following recovery were the longest such events since the Great Depression, and no wonder as it was the consequence of the wild, untamed decades of deregulating financial market activity culminating with the **Millennium Boom** and 2010 congressional re-regulation.

The Federal Reserve (the Fed) dropped their benchmark rate, the **Federal Funds rate**, to zero in April 2020. This rate is a monetary policy tool the Fed uses to induce and restrain levels of short-term borrowing in our economy. During business recessions, the Fed drops the target Federal Funds rate to encourage more borrowing and thus more capital investment and in time more jobs. During times of economic excess, the Fed raises their benchmark rate to reign in lending and borrowing activity to slow down capital investment and rising wages.

The Fed has stated their intention to leave the Federal Funds rate at its present **zero-bound** level until at least 2023. For real estate transactions, the Fed Funds rate directly affects the ARM rates paid on most commercial and some residential mortgages, whether they exist or are being originated.

In contrast, the **10-year Treasury Note (T-Note)**, the long-term rate which prompts rates on fixed rate mortgages (FRMs), plunged to its lowest rate on record in 2020, bouncing back to 1.08% as of January 2021, and rising as the third round of stimulus becomes a reality. Heading into the 2020 recession, declining business activity led bond market investors to accept significantly lower yields in return for the safety of treasuries and shun investment in mortgage-backed securities (MBS). Today, the only lender to keep interest rates on track with the T-Note is the Fed, which purchases most MBS and thus is the source of funds for FRM originations for a few years. [See Figure 1]

By 2024, the recession will fade in the rearview mirror due primarily to massive stimulus spending. Stimulus in 2021 is propping up the economy by providing funds for the unemployed to spend and businesses to remain open as employers. With the Fed Funds and FRM rates controlled by the Fed until the recovery gets underway, likely around 2024, real estate professionals can expect FRM rates to remain at levels around 1.5% above the 10-year T-note. When FRM rates begin to consistently rise, buyer purchasing power will decrease and annual home sales volume and prices will decline, unless offset by wage increases.

The link between rates

A glance at the chart in Figure 1 demonstrates for the casual observer that the Federal Funds rate and 10-year Treasury Note rate are linked. But what is the connection?

Movement in the Fed's short-term rate directly alters **adjustable rate mortgage (ARM) rates**. The persons first affected by ARM rate movement are property owners whose properties are encumbered by ARMs. These owners will see their monthly payments soon increase or decrease when the Fed rate is adjusted, subject to ceiling and floor thresholds in their ARM note.

When the Fed rate increases during a recovery, pricing in the real estate market will lose support and sales volume will begin to slip. The opposite market reaction is induced when the Fed rate declines in a recession, as occurred in 2020 and 2021.

ARM rate movement is tied to figures in one of several indices, each directly reflecting the Fed's short-term rate movement. So, when the Fed raises rates, these index figures rise, and in turn ARM rates rise an equal amount.

However, the Fed rate's effect on fixed rate mortgages (FRMs) is harder to pin down as FRMs are only *indirectly and belatedly influenced* in reaction to the likely wage and inflation result of the short-term rate activity. For FRM analysis, the 10-year Treasury Note (T-Note) is the most influential rate to watch for setting the FRM rate and controlling its movement. The 30-year amortized FRM rate historically runs roughly at a 1.5% spread above the 10-year T-Note. [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—as occurred in the first half of 2020 at the outset of the global **2020 recession**. This surge in demand for bond investments increases **the price** of the 10-year T-notes while decreasing the rate of yield – interest rate earned on T-Notes.

When the Fed raises the short-term rate to bring on a routine slowdown in the national economy needed to cool wages and consumer inflation, the 10-year T-Note rises *around the same time* to accommodate the perceived risk of future inflation. The Fed increases the short-term rate in anticipation of economic improvement (reflected via inflation and excessive increases in

wages). 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 growth experienced as the U.S. economy heads into an expansion.

In turn, FRM rates rise and fall along the path taken by 10-year T-Note rate, as well as the Federal Funds rate — both in anticipation of increased or decreased economic activity. Conclusion: The Fed fights inflation and bond investors hunt for investment opportunities in an expanding economy — until investors don't when the Fed ramps up to aggressively fight excessive consumer inflation.

The Fed's members meet eight times a year in what is known as the Federal Open Market Committee (FOMC). During these meetings, the Fed sets their plans and goals for **monetary policy**. As part of their policy decisions, the FOMC sets their projections and targets for the Federal Funds rate.

Each FOMC participant's projection of the future target Federal Funds rate is plotted on what is called a "dot plot." For example, in the December 2020 FOMC meeting, all FOMC participants believed the rate would remain at its present zero-bound rate in 2020 (an easy guess, since this plot was created in December 2020). The same was true for 2021. Just one member believed the rate will rise in 2022, but by 2023 a handful of members see the rate rising above zero, while the majority still believe it will remain at zero in 2023.

Over the long run, the FOMC see the Federal Funds rate returning to around 2%-3%. But this long-run target will not be achieved until after the recovery is underway from the 2020-2021 recession.

In 2020, the Federal Funds rate the Fed sets to influence the economy has returned to the **zero lower-bound** rate. A zero rate constrains the usefulness of the Fed Funds rate to further motivate investment, create jobs, or increase inflation by dropping the rate lower. Even when rates linger at the zero lower-bound rate, the Fed is not willing to lower rates into negative levels to help lift the nation out of a recession.

So, the Fed turns to other tools to realize its inflation and employment goals.

To this end, the Fed has reset its annual inflation goal to reach and maintain an **average 2% annual consumer inflation rate** over time, a feat rarely achieved during the 2010's recovery from the Great Recession of 2008. Translation: after long periods of low inflation (such as during a recession), the Fed will allow inflation to rise above its 2% target for a few years to bring the annual average over a business cycle up to its 2% average annual goal.

This approach will lead to a higher inflation rate in some years and temporarily translate to more expensive goods and services. The Fed reasons that a temporary higher level of inflation will sustain a more robust forward

Federal Open Market Committee (FOMC) "Dot Plot"

The Fed's new policy looks beyond the Federal Funds rate

economy and jobs market. In turn, more individuals will be employed putting more dollars into consumers' pockets to make up for higher prices. [See Factor 1: Jobs]

With this approach by the Fed, the recovery period for the years following the 2020-2021 recession will be a series of strong short-term growth with moderation of economy activity between them – mini-recessions of great frequency compared to the decade long periods between recessions from 1982 to 2020.

To meet this average-annual inflation goal, the Fed will allow interest rates to run low for longer periods of time, stimulating investment and lending. This will generate a hotter economy for a couple of years to bring about the average annual inflation over a business cycle to 2% - which it has not averaged in a couple of decades.

*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. Of course, this would compel banks to charge depositors for holding their savings.*

Higher inflation for short periods means long-term investors will need to demand higher rates of return to make their investments worthwhile during those periods. For income-producing real estate sales, capitalization rates will increase driving prices down. When it comes to the bond market, that means higher interest rates, which will bump up FRM rates, too.

The Fed won't begin acting on its new 2% average annual inflation policy by allowing amounts of inflation greater than 2% until the U.S. economy has moved beyond the **2020-2021 recession** into a recovery, say, 2025.

What do the Fed's new policies mean for housing?

Over the next two-to-three years into 2023, FRM interest rates will remain near their present yield spread of 1.5% above the 10-year T-note rate (down from a spread of around 2.5% in 2019). This will keep buyers interested in purchasing homes and homeowners encouraged to refinance, unless the 10-year T-notes experience an exodus of bond investors seeking better investment opportunities elsewhere. Thus, buyer and owner activities based on low T-note and FRM rates will keep home prices somewhat buoyed in the 2021-2022 period. But since interest rates will not go lower without the Fed "going negative," the impact of Fed activity on the real estate sales volume and prices will diminish so long as today's low rates linger.

Chapter 19.2 Summary

The Fed's main tool to control wages and inflation in the economy has long been the Federal Funds rate. This is the rate charged on overnight funds lent to banks by the Fed. In turn, banks lend short-term funds to businesses and consumers to finance purchases of goods and services.

Recessions coincide with decreases in the Fed Funds rate. Specifically, when the economy enters a recessionary period, the Fed decreases their benchmark rate, making funds cheaper to borrow for banks and in turn consumers. This injects stability into the economy and lessens the depth of a recession. Following a recession and entering into the recovery portion of a business cycle, the Fed gradually increases the Federal Funds rate. This rate increase is the Fed's attempt to maintain a lid on the boiling pot to avoid an over-heated economy — evidenced by rapidly increasing asset prices and consumer inflation.

Movement in the Fed's short-term rate directly alters adjustable rate mortgage (ARM) rates. However, the Fed rate's effect on fixed rate mortgages (FRMs) is harder to pin down as FRMs are only indirectly and belatedly influenced in reaction to the likely wage and inflation result of the short-term rate activity. In turn, FRM rates rise and fall along the path taken by 10-year Treasury Note rate, as well as the Federal Funds rate — both in anticipation of increased or decreased economic activity.

Notes:

Factor 20: Taxation



Chapter 20.1

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.

consumer confidence

subsidy

Learning Objectives

Key Terms

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;

Tax credit subsidies in action

- 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

subsidy

The government support of a particular entity or activity. For homebuyers, these come in the form of tax credits.

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.

In 2020, a different kind of stimulus was passed to combat the pandemic, financial crash and underlying recession. Individual stimulus payments, a moratorium on foreclosures and interest rate action all in flated home prices.

Homebuyers do not grow on trees

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 arbitrated 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.

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;
- *have saved* and are no longer reticent about committing their savings to home equity in the form of a down payment; and

The down payment equity cushion

Lack of confidence

consumer confidence

An economic indicator measuring the degree of optimism consumers feel about their personal financial situation and the state of the broader economy.

- are assured *mortgage money is priced right*, is available and banks will offer them mortgages on terms that are reasonable and do not mask future risks.

Homebuyers are gradually regaining confidence in the California real estate market. It has taken time for the buying public to learn lenders and adjustable rate mortgages (ARMs) contributed significantly to the real estate crash of 2007. Speculators also played a role by increasing the severity of the boom and crash. It was not fixed rate mortgages (FRMs) and occupying homebuyers who brought on the mortgage crisis or fostered the Great Recession.

A *subsidy* is meant to bridge the span between what was and what is to be. The problem with this particular set of tax credits is that they built a bridge to nowhere, and when it ended, fell miserably short of its goals.

The gap in homeownership and thus sales left by the real estate bubble implosion needed to be bridged by the force of jobs, rather than tax credits. California finally regained the number of jobs held prior to the recession in 2014. However, when considering the interim population increase, our state didn't reach a full jobs recovery until 2019, just a few months before the historic job losses of 2020 arrived.

Chapter 20.1 Summary

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.

Chapter 20.1 Key Terms

consumer confidence	pg. 301
subsidy	pg. 300

The home mortgage tax deduction: pros and cons

Chapter 20.2

After reading this chapter, you will be able to:

- describe the mortgage interest tax deduction and the principal residence profit exclusion; and
- understand the end result of both housing subsidies.

principal residence profit exclusion

Brokers, lenders and builders alike contributed in their own way to the decline in homeownership following the Millennium Boom peak. California's homeownership rate peaked at 61% in 2005, falling back to 55.6% at the end of 2020 (and likely to decline once the foreclosure moratorium ends in the second half of 2021). 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 \$750,000 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.

Learning Objectives

Key Term

Housing subsidies encourage indebtedness and turnover, not homeownership

principal residence profit exclusion

A tax exclusion on profit from a home sale up to a set dollar amount.

The priced-in effect

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.

Catalysts of the American Dream?

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.

The interest deduction’s legacy

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 arbitrated 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. This was experienced in the huge, and mostly successful, backlash from the real estate industry in 2017, when federal lawmakers were considering doing away with the mortgage interest tax deduction. In the end, the ceiling for the mortgage interest deduction was reduced from \$1 million to \$750,000, a compromise. [See Chapter 20.3]

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

Benefits arbitrated away

Dumb agent rules for nondisclosure of knowledge

² *Carleton v. Tortosa* (1993) 14 CA4th 745; Calif. Civil Code §2079.16

Tax subsidies affect pricing

Ownership of family shelter is not motivated by tax considerations. However, tax subsidies do affect pricing.

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]

Change will benefit the homeowner

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. 303

Chapter 20.2 Summary

Chapter 20.2 Key Term

Chapter 20.3

Recent tax changes

Learning Objectives

After reading this chapter, you will be able to:

- describe how the ceiling on itemized deductions results in more households taking the standard deduction and increased tax liability;
- understand estate tax changes; and
- understand how annual income bracket adjustments will push more households into higher income brackets in the coming years.

Key Terms

bracket creep

standard deduction

mortgage interest deduction (MID)

Changes to itemized, standard deductions

In 2017, the Republican Tax Plan made numerous changes to how everyone reports, deducts and pays taxes beginning in 2019 for income earned in 2018.

The **standard deduction** that U.S. households take roughly doubled from 2017 to 2018 — good news for low-income renters, but mostly bad news for homeowners and individuals with high personal income, specifically:

- households that annually take the standard deduction will see a tax liability reduction since the deduction from taxation is now much higher; and
- most individual Californians will now take the standard deduction rather than **itemize**, resulting in higher taxes for about half the individuals who itemized, generating a higher deduction under prior rules. [See Figure 2]

For homeowners, the **mortgage interest deduction (MID)** can only be taken if a homeowner itemizes their taxes. However, due to the higher standard deduction, fewer homeowners will need to take the MID in 2019 as to itemize will not produce a larger deduction.

For those who have itemized their deductions — and will continue to itemize under the new plan — some significant changes include:

- **state and local (SALT) taxes** are now limited to \$10,000 per tax return (the same for single and joint filers);
- the **ceiling for the MID** has lowered from interest on mortgages of up to \$1.1 million to interest paid on \$750,000 — and interest on **home equity loans (HELOCs)** only qualify for the MID when they funded home improvements; and

standard deduction

The income tax deduction which taxpayers who do not itemize their deductions may subtract from their incomes when calculating income tax payments.

mortgage interest deduction (MID)

An itemized deduction which allows mortgaged homeowners to deduct their mortgage interest paid in a tax year from their incomes when calculating income tax payments.

- the deduction for **moving expenses** is eliminated for all except for military families.

These changes have already had a significant impact in states like California where SALT taxes and mortgage amounts are both higher than average. The state's high cost of living translates to higher tax amounts for residents. But under the old tax rules, SALT taxes used to be *fully deductible*. Now, they will only be deductible up to \$10,000. For reference, the average Californian pays \$18,438 in SALT taxes as of 2015. This means typical taxpayers in the state will now be paying taxes on at least an additional \$8,438 in income.

California's average SALT bill is the third-highest in the U.S. This is due to the state's income tax rate and property taxes needed to fund services demanded of state agencies. Adding the \$10,000 cap increases the average Californian's federal tax payment by about \$4,000 over their prior full SALT deduction.

Income brackets have changed, as they do from year-to-year. But more importantly, the IRS will now measure inflation differently when making annual adjustments to the dollar amounts of brackets in the coming years. This essentially equals an insidious **tax increase** from year to year, as peoples' future income taxes will increase more quickly than the consumer price index (CPI) measure and thus wages.

The new CPI measure to be used is **chained CPI**. The difference between the new measure and the way inflation was previously measured is the new measure accounts for *consumer substitution patterns*. Consider the example used by the Bureau of Labor Statistics (BLS), which publishes the chained CPI figure: when the price of beef rises, the traditional form of CPI uses this higher price of beef to increase the CPI measure directly. But the chained CPI figure accounts for consumers who might actually *substitute* another meat which hasn't experienced a price increase, say, pork.

The overall effect is for chained CPI to rise more slowly than the traditional CPI measure. In turn, tax brackets will also rise more slowly. This means, when household income rises in the future, people will be **shifted into higher tax brackets more quickly** than under the old measure when inflation elevated these brackets more in line with rises in personal incomes. [See Figure 1]

Taxpayers will suffer what is termed **bracket creep**, when they move up into a higher tax bracket despite no *real* increase in income (after deducting for inflation). True, their income may have increased from the previous year, but not enough to actually up their purchasing power since consumer inflation exceeded their income increase.


The Tax Policy Center estimates the new CPI measure alone will equal an additional \$125 billion in tax revenue by the year 2027, paid mostly by middle-income earners. This increase will be small at first, but will add up to more money paid each year by taxpayers as they are bumped into higher tax brackets.

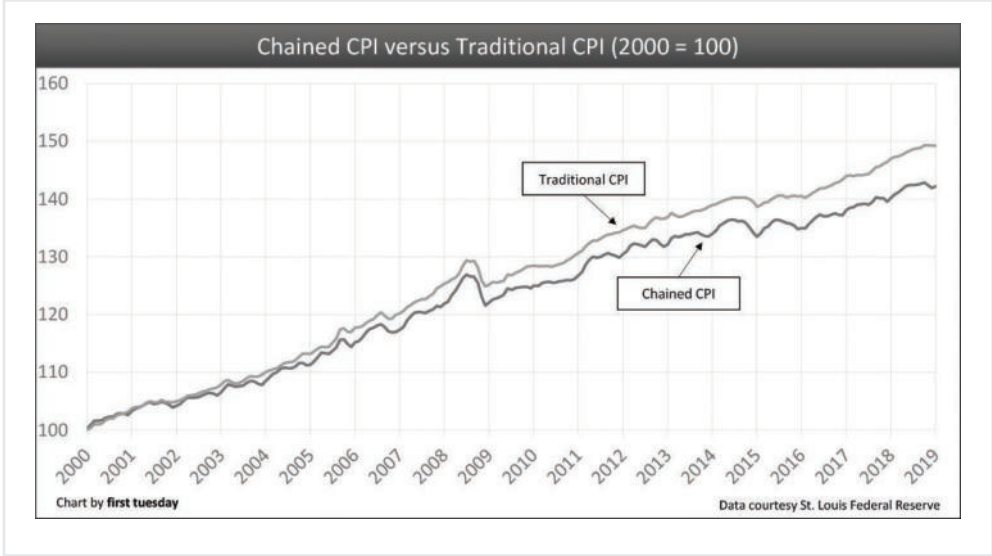
CPI set to shift your income bracket

bracket creep

When taxpayers move up into a higher tax bracket despite no real increase in income, resulting in higher tax payments.

Figure 1
Chained
CPI versus
Traditional CPI
(2000 = 100)


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



Estate tax changes

Very few individuals pay estate tax each year, and under the 2018 changes, this group has shrunk further.

The **estate tax** is a legacy tax on gifts (inheritance) left to family members or other individuals upon a person’s death. These taxable items include:

- real estate;
- cash;
- personal property;
- business assets; and
- insurance money.

However, the **Internal Revenue Service (IRS)** normally taxes very few estates when individuals receive items upon a person’s death. This is simply because most individuals don’t exceed the threshold or *lifetime exclusion* for being taxed on their wealth at the time of death, as it was quite high under the old rules and is even higher under the new rules.

For example, under the new rules a single filing jointly won’t pay any taxes on inherited estates unless the estate exceeds \$11.2 million. Thus, this “tax cut” impacts an extremely limited number of taxpayers. [See Figure 2]

Individual mandate removed

Taxpayers who don’t carry health insurance will no longer pay a penalty for remaining uninsured — this was called the **individual mandate** to induce everyone to be insured no matter the level of personal health.

The impact of repealing the individual mandate will be twofold:

- an immediate tax break for those taxpayers who did not have health insurance as they will no longer pay a tax penalty; and
- higher insurance rates for everyone who has health insurance.

Standard deduction amounts		
	Old rules	New rules
Single taxpayers	\$6,500	\$12,000
Head of household	\$9,550	\$18,000
Joint tax return	\$13,000	\$24,000

Estate tax amounts		
	Old rules	New rules
Single taxpayers	Up to 40% tax on estates above \$5.6 million	Up to 40% tax estates above \$11.2 million
Joint taxpayers	Up to 40 % tax on estates above \$11.2 million	Up to 40% tax on estates above \$22.4 million

Figure 2

Standard deduction amounts

and

Estate tax amounts

The reason? The individual mandate was an effort to induce more *healthy* people to sign up for health insurance. These additional premiums helped insurers keep their costs down, and if not, the government collected a tax penalty to cover the increased cost of government payments to health insurers.

But now that healthy people don't face a penalty for enrolling in basic health insurance plans, insurers are left with a higher share of sick people on insurance since healthy individuals will opt out. When more of the insured are using their health plans because of illness or other ailments, insurance become more costly.

However, the 3.8% tax on net investment income and profits added by the Affordable Care Act remains in place under the new rules. The **Affordable Care Act** added a 3.8% tax on **net investment income and profits** (classified as unearned income) when *modified adjustable gross income (AGI)* exceeds a threshold of \$250,000 for joint filers (or \$200,000 for single filers). For real estate investors, this includes income and profit from:

- the operations and sale of rental property; and
- interest income on savings and trust deed notes, earnings on land held for profit and rents received on triple net leased property.

Beginning in 2018 and through 2026, taxpayers may choose to *defer* the gain from the sale or exchange of property when the money is reinvested in a qualified **opportunity zone** within 180 days of the sale.¹

This rule rewards investors who put money into low-income areas which don't often see investment, designated *opportunity zones* by California's state government. Much like a §1031 exchange, the profit does not "disappear" in the eyes of the IRS. Rather, it is deferred until the investor sells the property or until December 31, 2026, whichever comes sooner.²

Another change ushered in during the 2018 tax year is a decrease to the **corporate tax rate** for C corporations (a corporation taxed separately from its

**Other
miscellaneous
changes
impacting
real estate**

¹ 26 United States Code §1400Z-2(a)

² 26 USC §1400Z-2(b)

owners as distinguished from S corporations, partnerships and LLCs). Many brokerage firms are structured as C corporations and thus the decrease applies to them. Previously, the corporate tax rate for C corporations was graduated, capping out at 35%. Now, the corporate tax rate is a flat 21%.³

This tax reduction not only hugely decreases the amount of money C corporations owe the IRS, but it effectively increases the value of C corporation ownership – the investors holding the company stock.

The 2018 changes also include a cap to **net operating loss (NOL)** taken by a business. Previously, NOLs were able to offset up to the full amount of taxable income carried backward up to two years and forward by 20 years. Now, NOLs may only be carried forward, not backward, and the threshold is limited to 80% of the taxable income each year.⁴

*Editor's note — See **Realtipedia** Volume: Tax Benefits of Homeownership on your student homepage for more information.*

Tax changes impact home values

Before the 2018 tax changes, taxpayers who itemized their deductions were able to deduct the full amount paid in SALT taxes each year, essentially avoided the compounding of paying federal taxes on their state tax payments.

Now, SALT deductions are capped at \$10,000 — the same for single and married taxpayers. For many Californians (and other taxpayers located in high-tax and high-income states, like New York and New Jersey), their SALT taxes well exceed the new cap. This translates to being taxed at the federal level on additional taxable income that under previous rules was deductible in full.

When it comes to housing, taxpayers with the most expensive homes — and thus higher property tax payments — are also paying more federal taxes under the new SALT limit. Higher tax payments by wealthier individuals will have a domino effect on home sales in California, causing **reduced home values** in high-tier residential properties, according to a study by the Cleveland Federal Reserve Bank.

The CFRB study finds the average home value change across the U.S. will be -5.7%. In other words, home values will be 5.7% lower than they otherwise would have been under the old rules which allowed taxpayers to deduct their full SALT payments.

However, due to the state's higher home values, this reduction will be much more significant for California's homeowners. Here, the average price difference due to the SALT cap will be:

- -8.7% in Vallejo;
- -8.6% in Oakland;
- -8.6% in Riverside;
- -8.5% in San Diego;

³ 26 USC §11(b)

⁴ 26 USC §172(a); (b)

- -8.4% in Los Angeles;
- -8.4% in Bakersfield;
- -7.7% in San Jose;
- -7.1% in Stockton;
- -7.0% in Fresno; and
- -5.9% in San Francisco.

This downward pressure on prices is on top of any other market factors — recoveries, recessions, immigration, trade – which push and pull on prices. For example, while falling interest rates gave home prices a boost in 2020, these home price increases might have been even greater without the SALT caps. With interest rates now beginning to rise, expect home prices to reverse course.

In 2017, the Republican Tax Plan made numerous changes to how everyone reports, deducts and pays taxes beginning in 2019 for income earned in 2018.

These changes include shifts in how income tax brackets are calculated, which will ultimately result in bracket creep and higher tax payments over time. Changes were also made to the estate tax, itemized deductions and the standard deduction. The mortgage interest deduction (MID) ceiling has been decreased from \$1.1 million to \$750,000. State and local taxes (SALT) have also been decreased to \$10,000 for single and joint filers alike.

All of these changes will result in higher tax payments for most middle-income California taxpayers over time. The SALT limit in particular will also pull back future home values, especially those in the high tier which were more reliant on the MID ceiling, which was higher under the old tax laws.

bracket creep pg. 309
mortgage interest deduction (MID)..... pg. 308
standard deduction..... pg. 308

Chapter 20.3 Summary

Chapter 20.3 Key Terms

Notes:

Factor 21: Population growth



Golden State population trends

Chapter 21.1

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.

emigration

**Individual Taxpayer
Identification Number (ITIN)**

undocumented immigrant

universal homeownership

Learning Objectives

Key Terms

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.

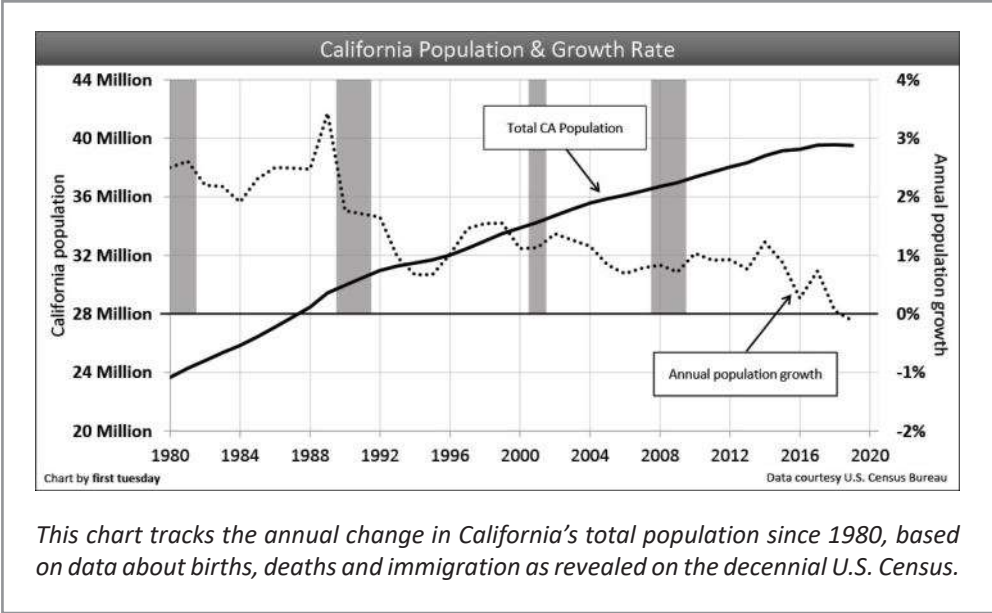
To that end, both state and federal governments provide extensive information about California's changing population.

California's rate of population growth varies wildly from year to year. However, it has always increased over time — until 2019. According to the

Population change: the last thirty years

Figure 1
California Population & Growth Rate

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



U.S. Census Bureau, California's population has continually increased over the past century, experiencing its first decrease in living memory in 2019. [See Figure 1]

Rate of population growth in the Golden State

Even though California's population continued to grow in recent decades, its growth rate since 1990 has been slightly lower than that of the nation as a whole, and continued to decline in the 2010's. [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]

Population growth in the modern age

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%.

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 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.

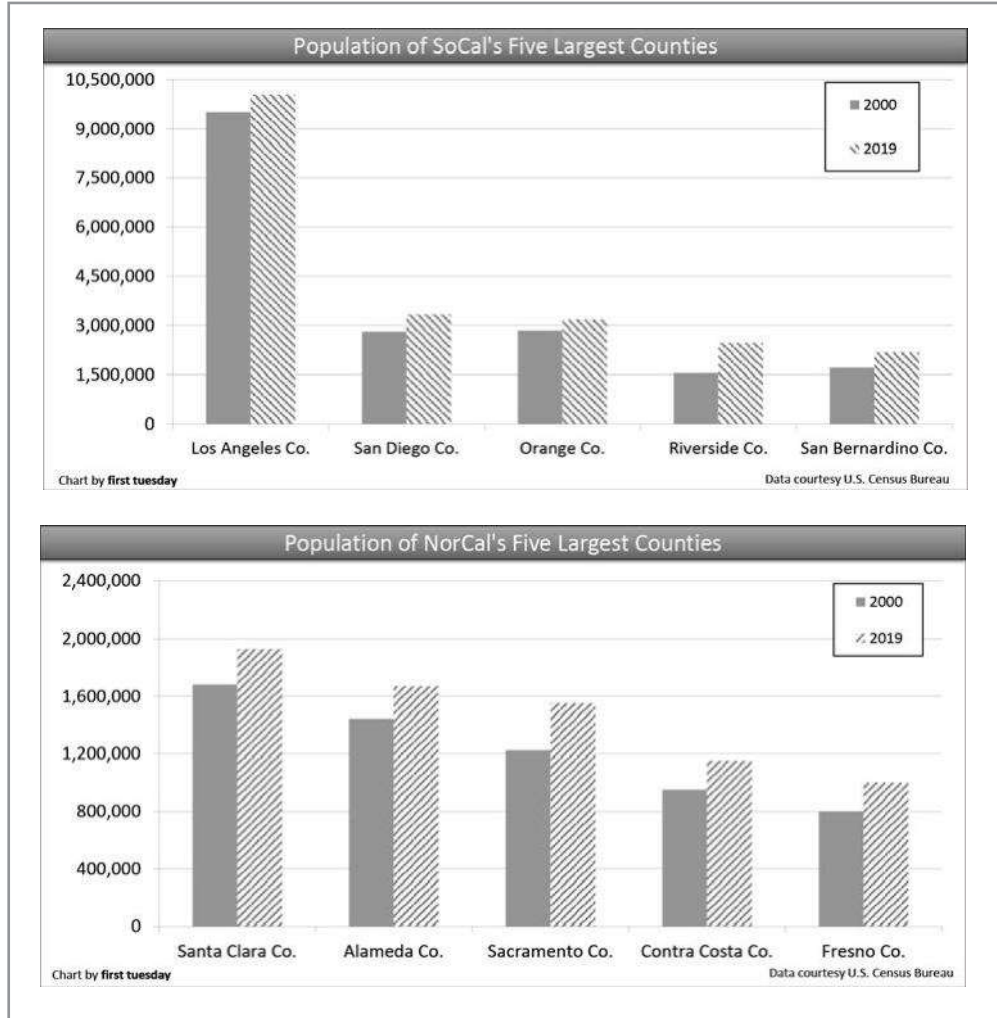
This drop returned prices to their historic trend of slow but dependable long-term increases. The price drop corrected for the distorted pricing that drove the population away from California in 2000-2006, a condition in pricing that is now underway in California's Bay Area.

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.

Figure 2
Population of SoCal's Five Largest Counties and Population of NorCal's Five Largest Counties



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

emigration
 The act of leaving a country or state for another.

undocumented immigrant
 An individual who enters a country without the approval of that country.

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 immigration

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.

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 925,000 people between 2000 and 2019; an increase of 60%. San Bernardino County was a distant second, growing 28%. 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.

Demographics of interstate migration

Location is everything when moving

Areas which saw less dramatic growth, like San Francisco and parts of Los Angeles, suffered far less and recovered more quickly than Riverside.

The new appeal of urban living

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.

universal homeownership

The idea that everyone can and should be able to own a home. Similar to the American Dream policy.

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 6: 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.

Population anticipated to lag

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.

In 2018, 156,100 more individuals moved out of California than moved in from other states. This number of individuals is hardly a mass exodus in the context of California's staggering 38+ million population. However, 2018 continued the negative migration trend experienced since the early 2000s. During California's 2006 domestic migration trough, nearly 300,000 more individuals left the state than entered from other states.

However, consistently net positive **international immigration** has tended to continue to boost total migration numbers, keeping net immigration positive in California prior to 2018.

Although nothing is certain when predicting the future, one thing does seem highly probable: as long as the cost of living continues to exceed incomes, California’s population growth will be hindered.

California’s population declined for the first time in living memory in 2019 (the most recently reported Census year), down a slight 0.1% from the prior year. This decrease continues a declining growth rate experienced over the past decade. The annual rate of population growth is usually closer to 1%. Steady population growth is essential for the long-term health of the housing market, including new household formations and demand for residential rentals and sales. Expect California’s population to continue its decline as long as inventory remains constrained and the cost of housing rises above the pace of incomes.

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. 318
Individual Taxpayer Identification Number (ITIN) pg. 318
undocumented immigration pg. 318
universal homeownership pg. 320

Chapter 21.1 Summary

Chapter 21.1 Key Terms

Chapter 21.2

Immigration's impact on the housing market

Learning Objectives

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.

Key Term

entrepreneurial spirit

The old role of immigrants in the new real estate paradigm

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.

Immigrant labor increases the rate of employment

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.

Two spheres of labor

Innovative fuel for the economy

entrepreneurial spirit

Individuals exhibiting creativity and ingenuity. Willing to adopt new, innovative techniques to succeed.

Real estate's gray industry

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 21.2
Summary**

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.

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.

**Chapter 21.2
Key Term**

entrepreneurial spirit pg. 323

Population growth exceeds new housing; rents rapidly rise

Chapter 21.3

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.

Learning Objectives

California's housing crisis continues to worsen, leading to overbalanced increases in home prices, rents and homelessness. The main culprit is a major housing shortage, which has grown worse over the past decade.

New household formation outpaced residential construction in all of California's largest metro areas over the past decade. However, this began to shift in 2019. For every new household formed, there were:

- 1.2 new units built in Los Angeles County;
- 1.8 new units built in Orange County;
- 1.3 new units built in Riverside County;
- 6.3 new units built in San Diego County;
- 1.7 new units built in San Francisco County; and
- 5.3 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.

For example, During the 2000s, for every one **new construction** unit built in Los Angeles County, the population grew by two individuals. Considering the average household size fluctuates around two-to-three people, this rate of construction is fairly appropriate for a healthy housing market.

More households than housing

But in the years that followed, from 2010-2019, the average annual ratio was over twice that. For every new construction unit started annually, the population grew by roughly four individuals in Los Angeles, according to the U.S. Census.

Population growth ought to fuel new construction

Where population growth outstrips new residential construction, these areas experience a correlating drop in residential vacancies. In 2020, the vacancy rate in California residential property was:

- 0.7% for property occupied by homeowners (including those sold to a homebuyer and awaiting occupancy and unsold, vacant homes not for lease); and
- 4.1% for rental properties. [See Factor 11: Inventory]

For historical comparison, 1.2% is about average for California homeowner vacancies and 5.5% is a typical rental vacancy rate. Both types of vacancies rose during the overbuilding years of the Millennium Boom and dropped during the following recession to today's low levels.

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 2022-2023, helped along by statewide legislative efforts to boost inventory. The next Great Confluence of buyers is likely to occur in the years following the recovery from the 2020-2021 recession, when members of Generation Y and Generation Z are expected to hit the homebuying market in earnest. Then, multi-family construction will increase more significantly.

The rent is still too damn high

Laws allowing for greater density have been slow to take hold here in California and across the U.S. That's mainly due to vocal **not-in-my-backyard (NIMBY)** advocates who don't want to see their "neighborhood character" jeopardized with an influx of residents.

These barriers to density are in fact barriers to economic growth and a more stable housing market. When NIMBYs win, it places real estate professionals in the position where they need to compete for a handful of listings in a given neighborhood, even when demand is high.

In turn, homebuyers are forced to either pay high market value or abandon the search in their desired neighborhoods. Sellers are hesitant to place their homes on the market for fear of being unable to find suitable replacement property in their neighborhood or budget, keeping inventory further in check.

The solution is simple: more housing, brought about by increased density in desirable areas that are:

- close to jobs; and
- near public transit, to relieve parking requirements which take up available land.

There isn't enough new residential construction to accommodate new residents.

Where household growth outstrips new residential construction, these areas experience a correlating drop in residential vacancies. Both the rental and homeowner vacancy rates are well below average. This indicates residents in California are holding onto their housing, unwilling to move for fear of being unable to find adequate replacement housing.

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.

Chapter 21.3

Summary

Notes:

Factor 22: Demographic change



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.

per capita income

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.

Chapter 22.1

Learning Objectives

Key Term

**Your gain
from local
demographic
information**

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.

The proactive broker anticipates needs

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.

The future divined by the numbers

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.

Analysis and application

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]

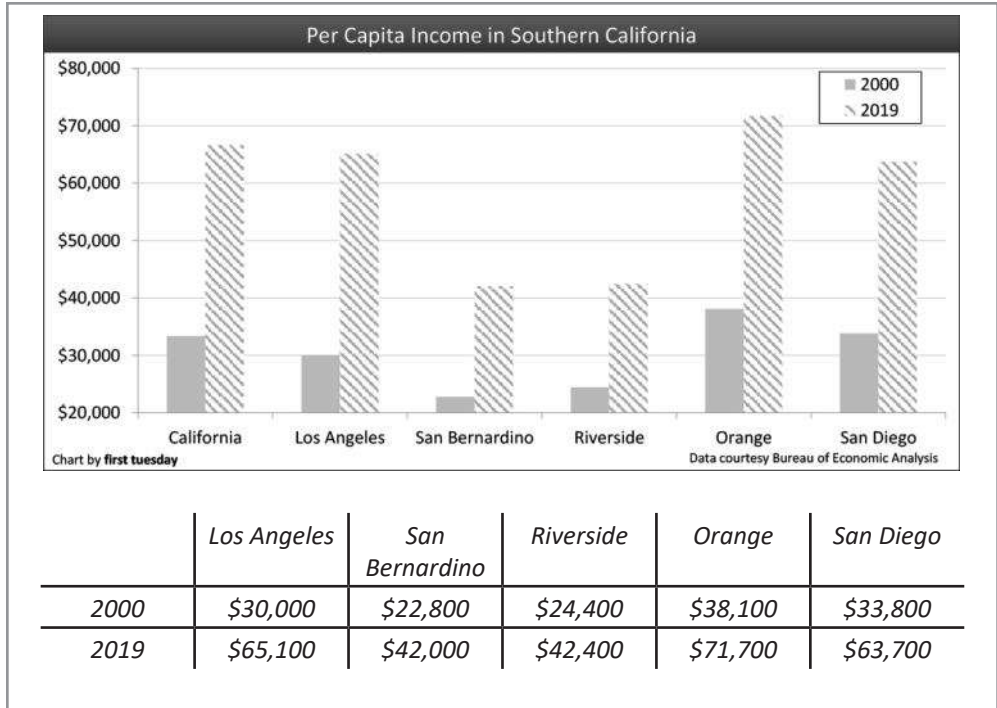


Figure 1
Per Capita Income in Southern California

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

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.

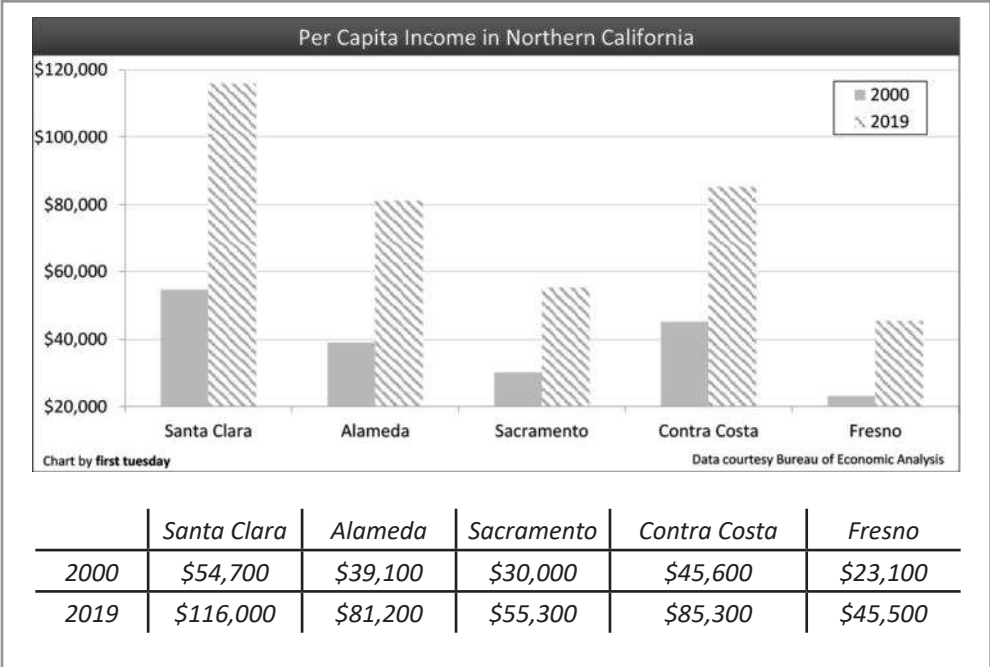
Different age groups, educational tiers and income classes have different real estate needs. Homebuyers and sellers in separate communities often pay *remarkably* different levels of brokerage fees per transaction for substantially the same service and talent. Here again, it is location that burnishes 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.

Different demographic, different needs

Figure 2
Per Capita Income in Northern California


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



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 benefit of specialization

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.

per capita income
A measure of average income per person in a population center.

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: Homeownership]

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.

**It all comes
back to
earning
power**

**Like attracts
like by
instinct**

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 Key Term

per capita incomepg. 332

Age and education in the Golden State

Chapter 22.2

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.

first-time homebuyer
median age

renters by necessity

Learning Objectives

Key Terms

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 nearly four years older in 2017 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]

Age and propensity to own


first-time homebuyer

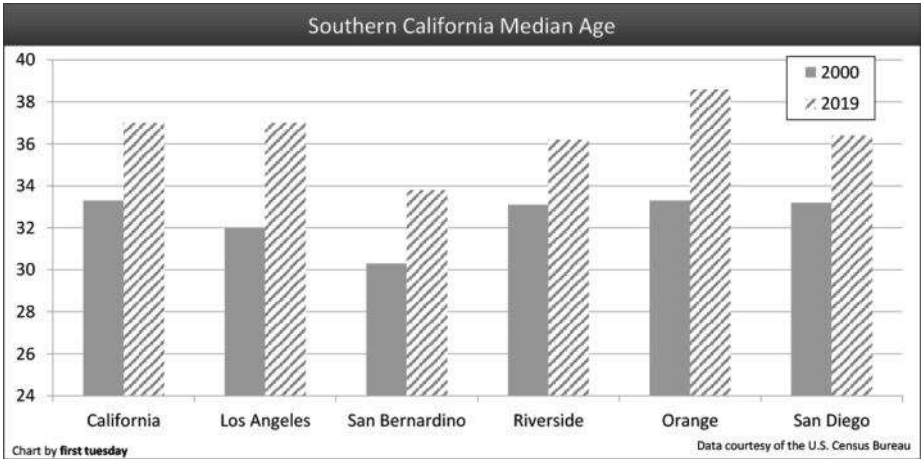
A buyer of a home who has not previously owned their shelter. Typically aged 25-34.

median age

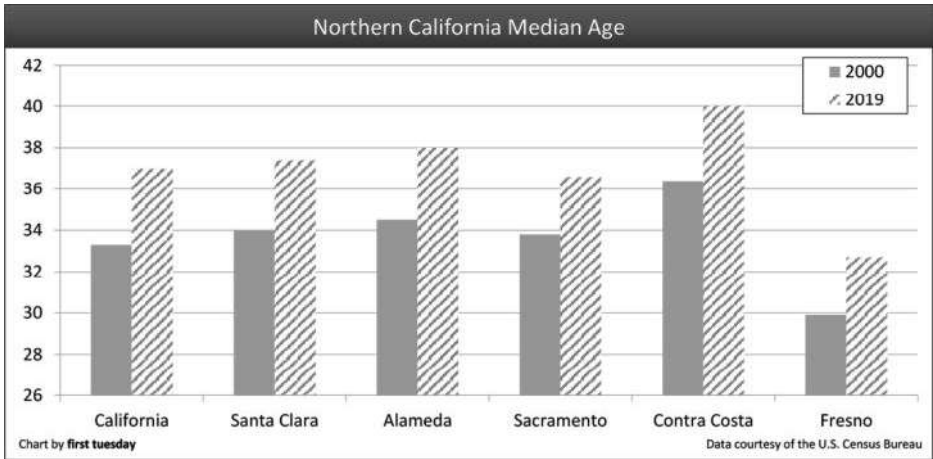
The midway point between the older half of a population and the younger half.

Figure 3
Southern California Median Age
and
Northern California Median Age


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



	<i>Los Angeles</i>	<i>San Bernardino</i>	<i>Riverside</i>	<i>Orange</i>	<i>San Diego</i>
<i>2000</i>	<i>32.0</i>	<i>30.3</i>	<i>33.1</i>	<i>33.3</i>	<i>33.2</i>
<i>2019</i>	<i>37.0</i>	<i>33.8</i>	<i>36.2</i>	<i>38.6</i>	<i>36.4</i>



	<i>Santa Clara</i>	<i>Alameda</i>	<i>Sacramento</i>	<i>Contra Costa</i>	<i>Fresno</i>
<i>2000</i>	<i>34.0</i>	<i>34.5</i>	<i>33.8</i>	<i>36.4</i>	<i>29.9</i>
<i>2019</i>	<i>37.4</i>	<i>38.0</i>	<i>36.6</i>	<i>40.0</i>	<i>32.7</i>

Editor's note – Figure 3 through Figure 5 track age and education levels in 2000 and 2017 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 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.

California southern sea change

Go inland, young man!

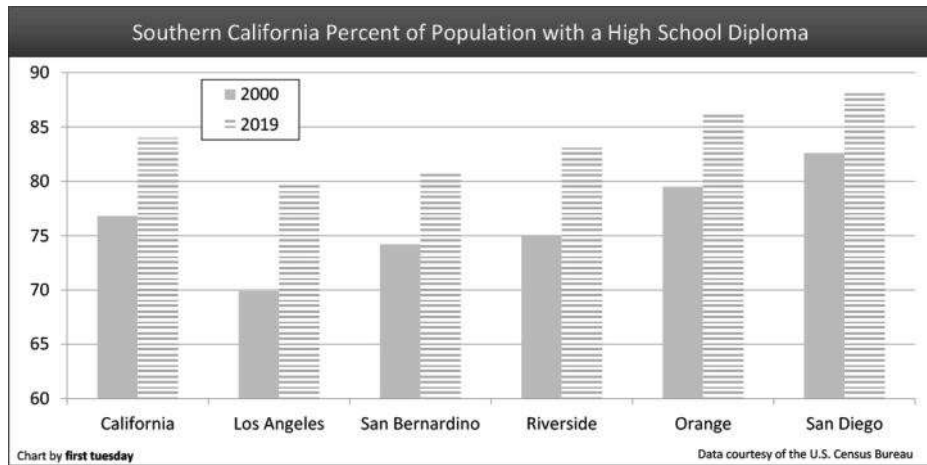
Real estate habits of an aging population

Figure 4


Southern California Percent of Population with a High School Diploma

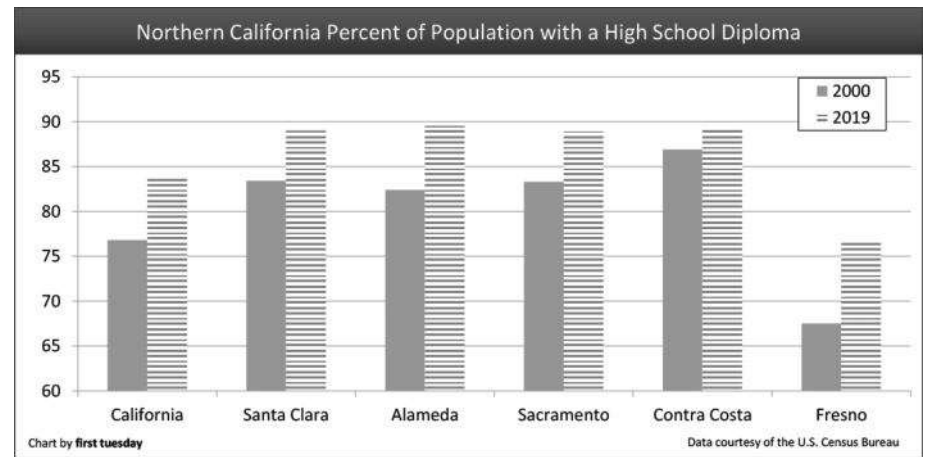
and

Northern California Percent of Population with a High School Diploma



	<i>Los Angeles</i>	<i>San Bernardino</i>	<i>Riverside</i>	<i>Orange</i>	<i>San Diego</i>
<i>2000</i>	69.9%	74.2%	75%	79.5%	82.6%
<i>2019</i>	79.8%	80.7%	83.1%	86.2%	88.1%


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	<i>Santa Clara</i>	<i>Alameda</i>	<i>Sacramento</i>	<i>Contra Costa</i>	<i>Fresno</i>
<i>2000</i>	83.4%	82.4%	83.3%	86.9%	67.5%
<i>2019</i>	89.0%	89.6%	88.9%	89.1%	76.6%

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]

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.

Education

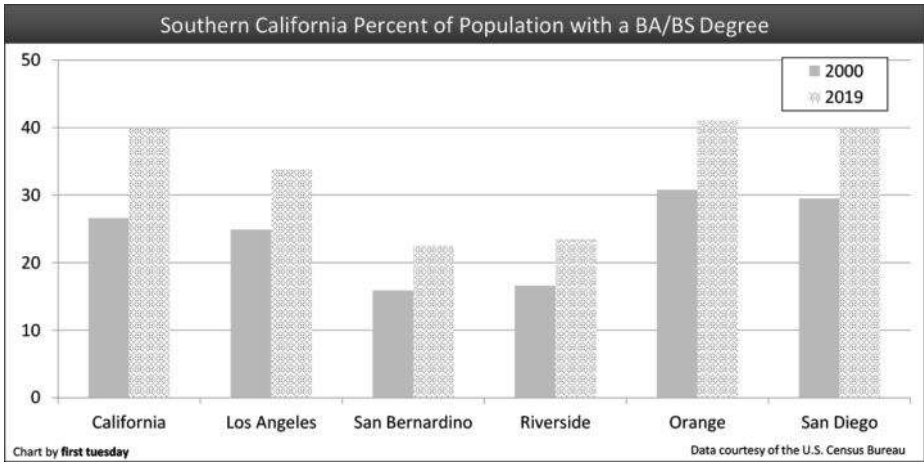
With age comes wealth

Lesser educated counties

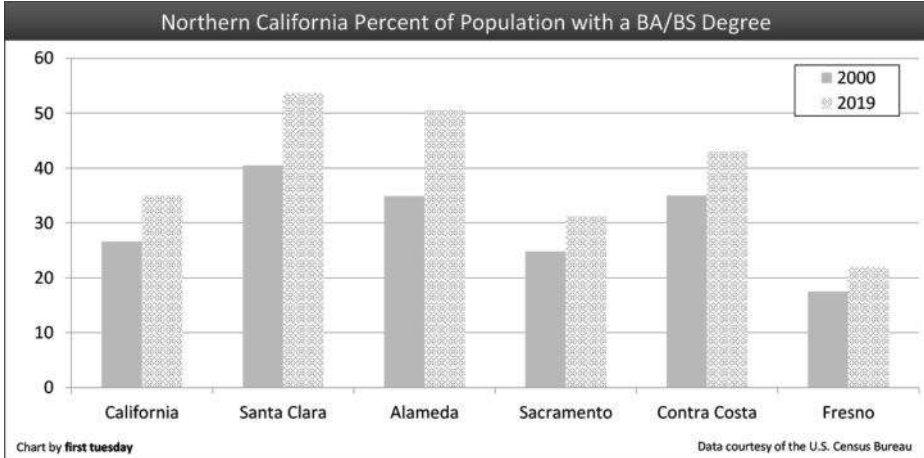
renters by necessity
Households for whom traditional ownership of their shelter is not economically possible.

Figure 5
 Southern California
 Percent of Population with a BA/BS Degree
 and
 Northern California
 Percent of Population with a BA/BS Degree


ONLINE UPDATE
 Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



	<i>Los Angeles</i>	<i>San Bernardino</i>	<i>Riverside</i>	<i>Orange</i>	<i>San Diego</i>
<i>2000</i>	24.9%	15.9%	16.6%	30.8%	29.5%
<i>2019</i>	33.8%	22.5%	23.5%	41.0%	39.9%



	<i>Santa Clara</i>	<i>Alameda</i>	<i>Sacramento</i>	<i>Contra Costa</i>	<i>Fresno</i>
<i>2000</i>	40.5%	34.9%	24.8%	35%	17.5%
<i>2019</i>	53.7%	50.6%	31.2%	43.0%	22.0%

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 65% homeownership rate in 2019, 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 struggled 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 pre-2020 recession levels in California, the central valley (especially Fresno) and the Inland Empire will remain challenging homebuying environments in the state. Statewide, employment is expected to return around 2024-2025.

Application to the market

A rocky future for California's central and inland valleys

Chapter 22.2 Summary

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.

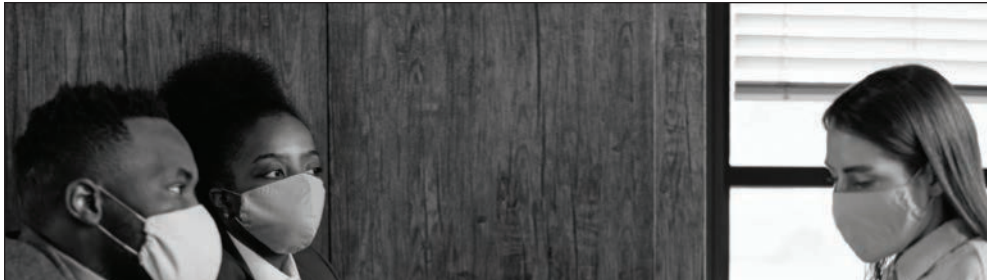
Young adults aged 25-34 tend to become dissatisfied with renting. With little encouragement, they will purchase their first single family residence (SFR). This demographic is known as first-time homebuyers.

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.

Chapter 22.2 Key Terms

first-time homebuyer	pg. 335
median age	pg. 335
renters by necessity	pg. 339

Factor 23: Pandemic



The economic impacts of pandemics

Chapter 23.1

After reading this chapter, you will be able to:

- link the 2020-2021 pandemic with the declining labor force participation (LFP) rate;
- understand the impacts of the pandemic on the stock market;
- learn how the Federal Reserve (the Fed) and federal stimulus programs work to counteract economic behavior during pandemics.

labor force participation (LFP)

As soon as news of the global coronavirus (COVID-19) pandemic's imminent arrival began to hit home in the first quarter of 2020, the economy reacted instantly.

Investors pulled their money out of riskier investments in favor of the government security offered by Treasuries. As a result, the troubled stock market tanked and the interest rate on the safe-harbor 10-year Treasury Note

Learning Objectives

Key Term

COVID-19's hard hit to the economy

hit historic lows. Consumers panicked, buying up everyday essentials and eschewing large, risky purchases. Businesses closed and workers lost jobs at alarming rates.

An **economic recession** was officially declared to begin in February 2020, just before the first shutdowns occurred in the U.S. in March 2020. The recession officially ended a short two months later in April 2020. While the 2020 recession was the shortest on record, its impacts continue to be felt in the economy as we look ahead to 2022.

Notably, while the recession took hold much faster and delivered severe impacts, the 2020 recession was already in the works long before the **coronavirus (COVID-19)** pandemic arrived. This was indicated by the negative **yield spread** seen in 2019. [See Factor 2: Interest rates]

The pandemic keeps workers at home

labor force participation (LFP) rate

The share of the population that is either employed or unemployed but actively seeking employment.

The global pandemic upended employment expectations, especially for families with young children and those near retirement. Many workers gave up employment income in order to care for children. Others near retirement age or with compromised immune systems chose to quit work in order to shelter in place. Still others gave up looking for jobs in their industry and have yet to return. With their exit from the workforce, the **labor force participation (LFP) rate** has dropped, and the unemployment rate has bounced higher than would have been accomplished by the sparse job additions of 2020-2021 alone.

When individuals drop out of the labor force — due to retirement, disability or other life changes that will keep them at home and out of the workforce — the LFP rate falls. When the LFP rate declines, so does **household wealth**, especially for that of middle-income households, which often rely on multiple streams of income to support the standard of living for a household. In turn, declining household wealth spells trouble for the long-term health of the housing market.

The LFP rate's falling trend

The LFP rate has declined since peaking in 2000 at just over 67% here in California. A steep drop occurred in 2009 during the **Great Recession**, the losses lingering during the long recovery that followed. During the last decade of recovery through 2020, California's LFP rate has remained roughly two percentage points below the U.S. average.

An even steeper drop in the LFP rate occurred during the ongoing **2020 recession**, from 62.6% in February 2020 to 59.0% in April 2020. It has since rebounded to 61.2% as of August 2021, still below the pre-recession LFP rate.

Today's lower LFP rate is a big reason why the **unemployment rate** has recovered quicker than anticipated. That's because when an individual drops out of the workforce, they are no longer included in the unemployment count, giving a false impression of an improving jobs market. The number of employed individuals is a more important figure for real estate, and

employment has dropped from the peak 17.7 million in December 2019 to 16.4 million in July 2021, reflecting 1.3 million Californians still without jobs who were employed at the close of 2019.

Real estate professionals who watch the LFP rate, along with jobs numbers, will find these trends more useful for forecasting future economic conditions than the misleading unemployment rate. Expect the LFP rate to remain at its present low level until the pandemic response subsides, possible by later in 2022.

Expect the LFP rate to remain at its present low level until the pandemic response subsides later in 2021 (or 2022) and jobs become available for those who are willing to work but have been unable to find a job demanding their skills. Governments may need to fill their role as the employer of last resort in the period of 2023-2024 to put people to work while private enterprise restructures as the employment engine sufficient to replace short-term government employment programs.

The Federal Reserve (the Fed) dropped their benchmark rate, the **Federal Funds rate**, to zero in April 2020. This rate is a monetary policy tool the Fed uses to induce and restrain levels of short-term borrowing in our economy. During business recessions, the Fed drops the target Federal Funds rate to encourage more borrowing and thus more capital investment and in time more jobs.

The Fed steps in

It also purchases **mortgage-backed securities (MBS's)** to keep mortgage interest rates low. Beginning in March 2020, the Fed began buying **mortgage-backed bonds (MBBs)**, thereby reducing the supply of MBBs. Axiomatically, a reduced bond supply means higher prices — and lower **yields**, reflected in lower interest rates. The Fed is expected to begin tapering their MBB purchases by the end of 2021, thus allowing interest rates to rise slightly. [See Factor 17: Monetary policy]

In contrast, the Fed expects to leave the Federal Funds rate at its present **zero-bound** level until at least 2023. For real estate transactions, the Fed Funds rate directly affects the ARM rates paid on most commercial and some residential mortgages, whether they exist or are being originated. This rate indirectly influences other types of interest rates, including fixed rate mortgage (FRM) rates.

The Fed took on its job of **lender of last resort**, a role it plays during times of extreme economic disaster. In this role, the Fed makes itself available as a lender to institutions with no alternative access to cash. [See Factor 17: Monetary policy]

It also encouraged banks to work with borrowers experiencing hardships due to COVID-19. Further, the Fed encouraged banks to make small-dollar loans to small businesses and consumers. These statements were eventually backed up by the force of law when federal legislation was passed to provide relief to consumers, businesses and homeowners.

The CARES Act and more stimulus

The **Coronavirus Aid, Relief, and Economic Security (CARES) Act** was signed into law at the end of March 2020, providing nearly \$2 trillion in stimulus to individuals and businesses affected by the pandemic.

The CARES Act helped homeowners by:

- creating a mortgage forbearance program for federally backed mortgage loans;
- protecting borrowers' credit scores from negative reporting during the crisis; and
- allowing financial institutions to temporarily suspend some requirements related to troubled debt restructurings (TDRs); and
- providing assistance to small businesses in the form of forgivable loans and paycheck protection.

The CARES Act set aside \$350 billion to assist small businesses. It also instituted some measures to provide loans and grants to small businesses, including the **Paycheck Protection Program (PPP)** and extending the Economic Injury Disaster Loan (EIDL) grants program to businesses impacted by COVID-19. It also expanded **unemployment benefits** for individuals personally impacted by COVID-19 or whose businesses were shut down as a result of the pandemic.

For tenants impacted by COVID-19, the CARES Act and subsequent legislation institutes an eviction moratorium. Under the moratorium, tenants were unable to be evicted through the end of August 2021, when the U.S. Supreme Court struck down the moratorium as unconstitutional. However, here in California, the moratorium lasted through the end of September 2021.

The other big-dollar expense of the CARES Act and following stimulus programs were the **stimulus payments** paid to individual taxpayers. The first stimulus payments went out roughly a month after the pandemic shutdown began, amounting to individual checks of up to \$1,200 per individual. In December 2020, an additional \$600 per qualifying individual was delivered, followed by \$1,400 per individual delivered in March 2021.

Large stimulus programs, including those seen during the 2020 recession, can help prop up economic activity during a crisis. The government needs to balance how much stimulus is sufficient to keep the economy from slumping and slipping into a depression or decade-long recovery (like the elongated recovery from the 2008 recession). At the same time, when the government takes their foot off the gas, will the economy be able to support itself? Or will a double-dip recession occur, as happened during the 1981-82 recession, which followed the 1980 recession.

The economy progress and the shape of the real estate market will be greatly impacted by government intervention in 2021-2022. The ultimate fuel for a recovery will be job creation, which stimulus programs have thus far avoided, but a tentative infrastructure bill may lean toward in 2022.

Despite the bleak employment picture, the stock market tells a very different story.

While the pandemic was on everyone's radar at the start of 2020, it didn't truly hit home until the stock market began to plunge in late-February 2020.

This happened after the **S&P 500** reached a peak just days before the crash, an example of the volatility that has characterized in the markets in the lead-up to and during the 2020 recession.

As a result, investors leapt out of the uncertainty of Wall Street into the safety of government bonds. This surge in investment caused the 10-year T-Note to nosedive to its lowest level on record — by a lot — landing below 0.5% in March. As more people found themselves stuck at home, the **price of oil** plummeted. That same day the 10-year T-Note hit an historic low, Wall Street trading was halted for a quarter hour in an attempt to convince investors to keep their cool, but the S&P 500 ended up falling over 7% in its worst day since 2008.

However, despite the significant losses in Q1 2020, the stock market rebounded rapidly, even alongside the continuing economic recession, evidence that the stock market continues to be detached from reality. With California's job numbers still 7.4% below the pre-recession peak as of July 2021, consumer spending will not be able to prop up businesses for long. For real estate, this means we are in a **hold phase** as savvy investors look ahead to the next buyer's market when home prices will hit a bottom, still a couple years away.

The stock market defies recessionary reality

Chapter 23.1 Summary

An economic recession was officially declared to begin in February 2020, just before the first shutdowns occurred in the U.S. in March 2020. The recession officially ended in April 2020, but the recessionary impacts continue to be felt due to a stalled jobs recovery going into 2022.

A steep drop in the LFP rate occurred during the 2020 recession, from 62.6% in February 2020 to 59.0% in April 2020. It has since rebounded to 61.2% as of August 2021, still below the pre-recession LFP rate. Today's lower LFP rate is a big reason why the unemployment rate has recovered quicker than anticipated.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law at the end of March 2020, providing nearly \$2 trillion in stimulus to individuals and businesses affected by the pandemic. Additional stimulus payments and extensions to the foreclosure and eviction moratorium continued throughout 2020 and into 2021.

Despite Wall Street's significant losses in Q1 2020, the stock market rebounded rapidly, even alongside the continuing economic recession, evidence that the stock market continues to be detached from reality.

Chapter 23.1 Key Term

labor force participation (LFP) rate pg. 344

Real estate professionals, socially distanced from clients

Chapter 23.2

After reading this chapter, you will be able to:

- describe how to conduct and rely on virtual showings for clients;
- understand appraisal waivers issued during the pandemic; and
- note buyer and seller behavioral changes in response to social distancing measures.

appraisal waiver

virtual showing

Learning Objectives

Key Terms

When the global pandemic response began to keep Californians at home in 2020, the housing market rapidly felt the negative fallout from a shuttered client base.

California's governor ordered individuals to shelter-in-place in March 2020, putting a halt to all non-essential activities outside the home. Real estate showings by agents or homeowners were not considered an essential activity. Therefore, homebuyers were unable to tour homes.

However, even in the face of a global pandemic, the need to buy and sell not only continues but is quickened by a demand for outdoor space. Brokerages with practice giving **virtual tours** and assisting remote clients quickly displayed their upper hand as prescient. At the start of the pandemic, Redfin, a national real estate brokerage, reported a 500% jump in virtual showing requests over the course of a single week.

Real estate professionals who wanted to continue earning fees during a pandemic need to offer virtual services. It's do-or-die for brokers, and those who succeeded during 2020 adapted quickly since by August of 2020 the buyers of spring had returned in full swing, ending the year 2020 with purchase volume nearly equal to 2019.

Shut in but eager to buy

virtual showing

A video-based tour of the property, provided in real-time with an agent or pre-recorded as part of their listing services.

Best practices for virtual tours and closings

While more difficult, homebuying and selling may still continue during pandemic isolation. County recorders by and large still record home sales. Other industry professionals can complete their work remotely, including title companies, mortgage lenders, notaries and even appraisers.

But how to induce homebuyers to purchase without actually setting foot on the property?

Homebuyers have increasingly become comfortable purchasing properties **sight-unseen** for years now, relying on listing photos and **virtual tours**. This is especially true in competitive markets where listings receive multiple offers within hours of going live. The difference during a pandemic is that the *vast majority* of offers need to be sight-unseen until shelter-in-place orders are lifted and the requirement for social distancing subsides.

To give their listings the biggest edge, seller's agents need to prepare for a significant chunk of potential buyers to be touring virtually or with the help of their agents via video chat.

This is most easily accomplished by ordering a 3D tour of the home, to be made available alongside the listing photos. There are numerous companies that offer virtual tour technology, including Matterport for residential homes and realync for multi-family properties. Asking a professional photographer who you're already familiar with is also a good place to start.

Most of the advice seller's agents give for homes receiving the virtual tour treatment is the same as with any listing. This includes de-cluttering and tidying up, and also providing ample lighting for the professional photographs and virtual tour – in the jargon of the agents, *staging*.

Seller's agents can also prepare additional **marketing materials** highlighting the area. Consider the aspects of the property that buyers won't be able to appreciate when they tour virtually and include those in your listing materials. Most importantly, make it clear that socially-distant buyers are welcome and the seller is willing to work with them to close the transaction during turbulent times.

Further, while some buyers may not feel comfortable touring during a pandemic, they may wish for their agent to make the tour for them. Agents do this on a video call with the buyer, answering questions for the buyer on the property specifics while doing the showing virtually. In this case, questions the agent can answer for the buyer that may not be immediately represented in photos or 3D tours include:

- What is the view out of the windows from various rooms?
- How close is the house to the neighbors?
- Are there any strong smells present, indoors or out?
- How is the noise level around the house?
- Do the plumbing and switches work?

Even the most thorough agent walkthrough doesn't replace a **home inspection report**, especially important when buying sight-unseen. Seller's agents are trained not to ask their sellers to give them authority to order out a home inspector for a report, paid for by the seller, and appear not to have learned the contractual importance of up-front seller disclosures when the buyer is not personally reviewing the property and will not be on notice of defects. Thus, the buyer's agent needs to recommend two or three home inspectors they trust to be unbiased and thorough for the buyers to choose from.

When showing properties in person, real estate offices need to establish a specific COVID-19 prevention plan. Agents need to discuss these prevention plans with the client before showing a home in-person. These rules need to include specific instructions for visitors about the use of face coverings, hand sanitizer, maintaining physical distancing and avoiding high-touch surfaces.

Surfaces ought to be cleaned and disinfected before and after each showing. Commonly used surfaces at shown properties include counters, sinks, toilets, light switches, door and cabinet handles and keypads. Proper cleaning protocols include:

- vacuuming, instead of sweeping, to avoid dispersing pathogens into the air;
- introducing fresh outside air during a showing by opening doors and windows and operating ventilation systems;
- disinfecting any equipment passing between workers and clients;
- ensuring properties are equipped with cleaning products, including hand sanitizer and disinfectant wipes;
- ensuring all agents, brokers, inspectors and clients wash hands with soap and water or use hand sanitizer upon entry and touring of any property; and
- modifying showings to provide enough time for proper cleaning and disinfecting.

Along with cleaning protocols, physical distancing plays a crucial part in showing homes and properties during a pandemic. And welcome everyone to the digital world of electronics. Here are some guidelines to follow when showing properties:

- use an appointment or digital sign-in process to control the number of people in a home or on a property;
- use virtual tours whenever possible;
- open doorways and other areas of ingress and egress prior to in-person showings;
- remind clients to maintain physical distancing during showings and refrain from touching any surfaces;
- disinfect any fixtures that may have been touched during the showing;

In-person showings during a pandemic

Physical distancing guidelines for showing properties

- ensure all inspectors and clients have access to handwashing facilities and hand sanitizer; and
- provide all information electronically.

Workplace-specific plan

The California Department of Public Health (CDPH) released a guide for workplace environments, which calls for a written COVID-19 prevention plan. The guidelines for workplaces include:

- incorporating face covering guidance into the plan, with a policy for handling exemptions;
- identifying contact information for the local health department;
- training and communicating with workers on the plan;
- regularly evaluating the workplace for compliance with the plan and documenting any deficiencies;
- investigating any COVID-19 illness and determining if work-related factors contributed to their illness;
- implementing proper protocols for an office outbreak, following CDPH guidelines; and
- identifying close contacts of any infected worker and isolating them and their close contacts.

By following and practicing these guidelines, brokers are protecting both their agents and other employees as well as their clients.

Further, beginning January 1, 2021 through January 1, 2023, employers — including real estate brokers — need to inform employees of potential exposure to COVID-19 at the workplace. Within one business day of receiving notice of potential COVID-19 exposure, the employer needs to provide:

- **written notice** to all employees, including the employers of any subcontracted employees, who were on the premises at the time the infected individual was present during the infectious period;
- any disinfection or safety plan the employer will implement to address the COVID-19 exposure;
- information regarding COVID-19 related benefits to which the employee is entitled, such as:
 - workers' compensation;
 - COVID-19-related leave;
 - company sick leave;
 - state-mandated leave; and
 - anti-retaliations and anti-discrimination protections. [Labor Code §6325 (a)]

When a COVID-19 **outbreak** occurs among employees, the employer needs to notify the local public health agency, providing the names, number,

occupation and worksite of the infected employees. The CDPH defines an outbreak as three or more COVID-19 cases occurring within a two-week period.

When a working environment poses an imminent risk of infection, the employer needs to prohibit entry into the immediate area where such risk exists. [Lab C §6325 (b)]

Of note: California's new notification requirements are not a free pass to violate **privacy laws**. Any notifications provided to employees may *not* include identifying characteristics or names of the infected individuals.

For mortgage originators to keep up with demand for mortgage money during the pandemic-induced, lowest-ever mortgage rates, **appraisal waivers** become more acceptable and more common.

In August 2020, the share of transactions which received an appraisal waiver was 38%, up from 24% in March 2020 at the start of the pandemic. By transaction type, appraisal waivers were conducted in August 2020 for:

- 10% of purchase transactions, up from 5% in March 2020;
- 63% of rate/term refinances, up from 49% in March; and
- 26% of cash-out refinances, up from 13% in March, according to the Urban Institute.

Refinances became especially popular during 2020 due to the historic drop to mortgage interest rates. Without the rising permissiveness for appraisal waivers, many of these refinances would have been postponed if made at all, negatively impacting mortgage loan originations (MLOs). [See Factor 2: Interest rates]

Appraisals are meant to reduce the risk to lenders and ultimately to the agencies that guarantee mortgages, like Fannie Mae and Freddie Mac. Without an appraisal, a homebuyer may be approved for a mortgage which exceeds the home's **fair market value (FMV)**, putting the mortgage holder at risk.

Is the rapid increase in appraisal waivers a sign of danger in the market?

The Urban Institute correctly points out that the majority of the appraisal waivers being allowed in 2020 are for refinances, which are by and large already held by Fannie Mae and Freddie Mac. Further, these refinances offer lower payments or better mortgage terms for homeowners, which is only helpful to reduce the likelihood of future default if there are no further job losses as the 2020 recession and pandemic consequences work their way forward to the point a long-term recovery trajectory is underway. That will not be known until around 2024-2025 at the earliest.

Appraisal waivers fuel the refinance wave

appraisal waiver

The option for a homeowner or homebuyer to have their property appraised based on automated information to generate an appraised home value, rather than with a walkthrough viewing of the physical property.

However, the rising trend in appraisal waivers for purchase mortgages is something to watch with caution.

Extending closing

During a pandemic, flexibility is key.

Homebuyers and sellers may choose to extend closing dates as they wait and see how the economic fallout from the pandemic impacts their plans. Drastically altered plans by everyone is what a pandemic does to people, and the permanence of any plans will not be known for months, possibly years to come. Others may simply be unable to complete all escrow tasks within the originally agreed-to time period. There are options available to **extend closing**.

As a matter of policy, **RPI** Forms do not contain “time essence” provisions. When you need to extend closing scheduled under an existing purchase agreement, simply use RPI Form 250 as a general addendum to your current purchase or listing agreement. If not, then notices to perform providing a reasonable time period for the buyer to close are the seller’s best enforcement effort. [See **RPI** Form 250]

Chapter 23.2 Summary

While more difficult, homebuying and selling may still continue during pandemic isolation. County recorders by and large still record home sales. Other industry professionals can complete their work remotely, including title companies, mortgage lenders, notaries and even appraisers.

When showing properties in person, real estate offices need to establish a specific COVID-19 prevention plan. Agents need to discuss these prevention plans with the client before showing a home in-person. These rules need to include specific instructions for visitors about the use of face coverings, hand sanitizer, maintaining physical distancing and avoiding high-touch surfaces.

Brokers need to develop workplace guidelines to promote health and safety during a pandemic. By following and practicing these guidelines, brokers are protecting both their agents and other employees as well as their clients. Further, beginning January 1, 2021 through January 1, 2023, employers — including real estate brokers — need to inform employees of potential exposure to COVID-19 at the workplace.

Chapter 23.2 Key Terms

appraisal waiver	pg. 353
virtual showing	pg. 349

Eviction, foreclosure moratoriums build the shadow inventory

Chapter 23.3

After reading this chapter, you will be able to:

- identify the eviction and foreclosure moratoriums of 2020-2021; and
- discuss how this builds up the inventory of future foreclosures and vacancies.

shadow inventory

Learning Objectives

Key Term

When millions of U.S. homeowners lost their jobs in 2020, the government instituted a **foreclosure moratorium**, which allowed homeowners to remain in their homes during the pandemic. During a moratorium, mortgage servicers are prohibited from starting or moving a mortgaged home through the foreclosure process.

A moratorium on foreclosures

The moratorium remained in place through August 2021, when the Supreme Court struck down the final eviction moratorium as an overreach of the Centers for Disease Control's (CDC's) powers. The FHA, VA and USDA enrollment window for mortgage forbearance programs lasted through September 30, 2021 and other types of mortgages may still continue to qualify for forbearance at the discretion of the servicer.

As of the third quarter (Q3) of 2021, 1.5 million homeowners or 3.0% of mortgaged homes were in a forbearance program. Federally backed mortgages have up to 18 months of forbearance available to them.

Of the homeowners who exited forbearance during Q3 2021, 16% exited behind on payments and with no repayment plan in place. These homeowners are headed for foreclosure or a forced sale immediately upon expiration of the foreclosure moratorium.

Considering all U.S. homeowners who exited forbearance programs from June 2020 through March 2021:

- 8% exited by selling the home;
- 8% exited with a loan modification plan in place;

- 14% exited behind on payments and without a loss mitigation plan in place; and
- the remaining 68% were able to either reinstate their loan, catch up on payments or defer their loan payments, according to the Mortgage Bankers Association (MBA).

Today's delinquencies are the shadow inventory

As of Q3 2021, 5.5% of all mortgages were delinquent, or 30+ days past due. The vast majority were in a serious stage of delinquency, or 90+ days past due. In all, 4.0% of all mortgaged homes were 90+ days delinquent in Q4 2020.

18 months of the eviction moratorium in place has caused delinquency levels build. Now that the expiration deadline has finally arrived, will a flood of foreclosures hit the market, as during the fallout from the 2008 recession?

While the moratorium on foreclosures has kept homeowners housed during a time when the pandemic makes the loss of home dangerous for the health of all residents, it has pushed off the inevitable.

The underlying economic conditions that caused the **2020 recession** will not be cured by an end to the pandemic. Historic job losses will not be restored overnight, nor will they all return quickly.

As job losses linger, the number of households with serious delinquencies will continue to rise. With the end of the foreclosure moratorium, these delinquent mortgages will head for foreclosure or a forced traditional sale in a building wave.

Think of today's delinquent mortgages as the **shadow inventory**. These serious delinquencies are not yet tangible in the market, but they reflect the future sales to eventually be added to the inventory. The longer the shadow grows, the greater the tidal wave of inventory to come.

shadow inventory

The inventory of properties whose pending release onto the market (e.g., REOs, foreclosures, speculator holdings) will destabilize real estate sales volume and prices.

RPI forecasts the end of the moratorium will impact home sales volume and prices heading into 2022. But the extent and duration of the impact will continue to depend on government intervention. After all, as of July 2021, California alone is still missing 1.3 million jobs compared to the December 2019 peak. Without jobs, homeowners and renters will be unable to resume making their housing payments when the moratorium is up, let alone pay back missing payments.

Loss mitigation potential

The Urban Institute believes the consequences of the moratorium expiration may not be as bad as many expect.

First, the Urban Institute notes **Fannie Mae** and **Freddie Mac** — which cover roughly two-thirds of U.S. mortgages — have established a “loss mitigation waterfall” which allows homeowners to push the payments accumulated during the forbearance program through to the life of the loan. Thus, they will not owe a lump sum of missed payments at the end of the forbearance period, simply continuing their pre-forbearance payment. As

long as these homeowners are able to obtain a job with roughly the same level of income as before they entered the program (presumably due to a job loss), they will be able to resume mortgage payments, avoiding foreclosure.

The Urban Institute also points out that many of these delinquent homeowners not in a forbearance plan may actually have sufficient **home equity** to sell their home without the need for foreclosure. Since home values have yet to decline during this recession, this positive equity condition is a stark contrast from the 2008 recession, which plunged those who purchased during the latter half of the Millennium Boom into negative equity. Underwater and jobless, a distressed sale was the only option. That is not the case going into 2022.

While positive equity and the ability to put off repaying missed payments will be enough for some, they will not save everyone from foreclosure.

The underlying recession accompanying the **pandemic** continues to hinder the jobs recovery, hence the continued need for the band-aid solution of additional stimulus payments. It's impossible to believe that all jobs lost will be fully returned by 2022. (For comparison, it took over a decade for California to regain all jobs lost when counting population gain following the 2008 recession).

Therefore, even if everyone in a forbearance program takes advantage of the option to push the missed payments down the road, there will still be plenty of homeowners not in a forbearance program who will be forced to sell their home, be it through foreclosure or through a traditional positive equity sale. Either way, **multiple listing service (MLS) inventory** will swell. Rising inventory, alongside the recent increase in interest rates which has reduced purchasing power, will tip the market into a **vicious cycle**, and home values will decline, pushing more homeowners underwater.

To be certain, no one expects the same level of foreclosure crisis that occurred in the years following the Millennium Boom. But real estate professionals who prepare now for the return of distressed sales will be in the best position to continue to make a living in the coming months when the shifting housing market emerges.

Chapter 23.3 Summary

When millions of U.S. homeowners lost their jobs in 2020, the government instituted a **foreclosure moratorium**, which allowed homeowners to remain in their homes during the pandemic. During this moratorium, mortgage servicers are prohibited from starting or moving a mortgaged home through the foreclosure process.

As the expiration continues to be pushed back and delinquency levels build, it leads us to question what will happen when the expiration deadline finally does arrive. Will a flood of foreclosures hit the market, as during the fallout from the 2008 recession?

While positive equity and the ability to put off repaying missed payments will be enough for some, they will not save everyone from foreclosure. **RPI** forecasts the end of the moratorium will impact home sales volume and prices going into 2022. But the extent and duration of the impact will continue to depend on government intervention.

Chapter 23.3 Key Term

shadow inventory pg. 356

Remote work transforms the commercial real estate market

Chapter 23.4

After reading this chapter, you will be able to:

- explain the demand shift away from retail and office space; and
- understand the surge for distribution space experienced by industrial brokerages.

availability

net absorption

infill

Learning Objectives

Key Terms

The commercial real estate market experienced a divergent performance in 2020, according to Voit Real Estate Services.

As the pandemic has escalated the move from in-person to online, demand for **industrial property** has been pushed to a new high. This move has been led by big-box fulfillment centers, which are popping up across SoCal occupying large distribution facilities – industrial space.

Availability of industrial property declined across SoCal in Q4 2020, as industrial space was snatched up by businesses seeking to fulfill a growing consumer demand for online ordering.

Despite rising demand, the number of square feet delivered declined this year. This decrease was largely due to social distancing measures, which slowed construction significantly during 2020. San Diego continues to be a bright spot for construction in SoCal. Los Angeles and Orange County are basically limited to **infill** properties, as there is no land available to build upon. The Inland Empire continues to see exponentially more industrial construction, with 16 million square feet delivered in 2020.

2.7% of industrial mortgages were delinquent at the end of 2020, according to the Mortgage Bankers Association (MBA), a low share compared to other commercial properties.

Demand for industrial space surges

availability

Property marketed for sale or lease.

infill

The development of vacant land located within existing urban areas to add value by making improvements.

Offices go remote

Unlike industrial, the office sector has experienced the ill effects of the 2020 recession and pandemic.

Demand for office space has declined and vacancies increased while businesses continue to terminate or send employees home to work remotely as forced on them by the pandemic. Having realized the cost savings for themselves and their employees of forgoing leased space, many businesses have decided not to return to an in-person work environment again.

However, while demand for office space is waning, just 2.4% of office building mortgages were delinquent at the end of 2020. This indicates that businesses who went remote are able to pay rent under unexpired, existing lease agreements.

net absorption

The percentage change in occupied space over a period of time, which can be positive or negative.

Construction of new office space has declined significantly over the past year, paced by decreased demand. This has occurred as negative **net absorption** fell further into the red in 2020.

Retail goes dark

Even worse than the office sector, retail has suffered significantly during this recession. Most retail businesses have struggled to cover costs during these times when consumers are doing their shopping online from home. Many have been forced to close, lay off employees or move their businesses online.

San Diego's **retail vacancy rate** is rising but was still just 4.7% in Q3 2020. Still, this is not yet reflective of the true vacancy rate. That's because eviction moratoriums in San Diego have kept some commercial landlords from kicking out non-paying tenants. Further, some landlords are not yet marketing their space as vacant or available. But as eviction moratoriums lift, vacancies will rise and availability will follow.

Absorption continued its dive below zero, with 1.3 million square feet of negative net absorption in San Diego alone during 2020. Retail construction also continues to decline, with just 193,000 square feet of new retail property delivered in 2020.

11% of retail loans were delinquent at the end of 2020. Unlike office environments, which may still complete most jobs while remote, it's much more difficult to justify a retail space when individuals are sheltering in place. As the economy continues to open up, retail will pick up. But by then, it will be too late for many retail businesses that have been forced to close.

Expect retail to continue to suffer in 2022. Retail businesses will continue to shutter until the pandemic response is ended and the impacts of the recession over. Even then, downward pressure will continue until jobs return, restoring consumer purchasing power.

Other property types

Faring worse than any other commercial property type in 2020, the **hotel and lodging industry** is looking extremely bleak.

Travel ground to a halt during the pandemic. Some hotels countered the loss by opening up their doors to healthcare workers who were either flown in to help with the pandemic or were too scared to spread the virus to their families at home. Still, at the end of 2020, 21% of lodging mortgages were delinquent.

With interest rates at historic lows, **refinances** have been the saving grace for an otherwise depressed commercial and multi-family market. For example, year-to-date (YTD) sales volume for the multi-family market is down 41% nationwide compared to a year earlier as of Q3 2020. At the same time, mortgage originations were down just 17%, the difference being made up by refinances.

Refinancing into lower payments is one way landlords have been able to recoup some of the income lost this year and remain current on their mortgages.

2020 saw a nationwide decrease of roughly one-third in commercial mortgage origination volume compared to the prior year. This decline was led by a decrease of:

- 77% for hotels;
- 69% for retail;
- 50% for office;
- 27% for healthcare facilities;
- 18% for industrial; and
- 8% for multi-family, according to the MBA.

While the largest declines held fairly steady throughout the year, by the end of 2020, industrial and multi-family were experiencing the fastest rebounds from the steep declines experienced during the first half of 2020.

A sustained recovery won't take hold until around 2023, once jobs begin to return in earnest and consumer behavior bounces back. At that time, sales volume and prices will begin to rebound from the economic losses of 2020 and the foreclosures expected to hit the market in 2022.

Commercial property owners, particularly those of office space, will need to be flexible as the trend morphs and grows in the years ahead. **Central business districts (CBDs)** will be most successful when they incorporate different types of flexible space, such as space that can be used as office space one year and residential the next.

At this point in the hangover from the 2020 recession, the commercial market most needing of flexibility is the **hotel industry**, followed by **retail**. These two industries have had the most obstacles adapting in the pandemic environment.

Commercial lending declines

Shifting commercial demands following the pandemic

Commercial property owners will need to get creative as the market adapts to the harsh pandemic realities, some of which are here to stay. Real estate professionals can help by strategizing alternative uses for properties that linger on the market.

Chapter 23.4 Summary

As the pandemic has escalated the move from in-person to online, demand for industrial property has been pushed to a new high. At the same time, retail and office experienced a decline in demand, reflected by rising vacancies and availability.

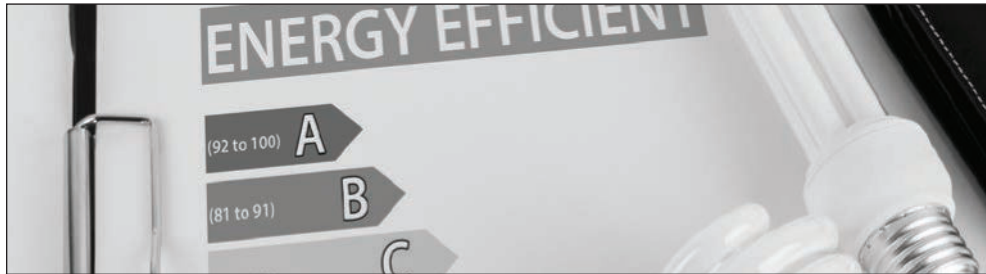
2020 saw a decrease of roughly one-third in commercial mortgage origination volume compared to the prior year. However, lower interest rates allowed landlords to refinance, in many cases making up for lost rent.

A sustained recovery won't take hold until around 2023-2024, once jobs begin to return in earnest and consumer behavior bounces back.

Chapter 23.4 Key Terms

availability	pg. 359
infill	pg. 359
net absorption	pg. 360

Factor 24: Energy consumption



Energy efficiency 101: for California real estate agents

Chapter 24.1

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.

building envelope
energy audit

energy efficiency
home energy score

Learning Objectives

Key Terms

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

Energy efficiency: what's the big deal?

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.

The Golden State goes green

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.

energy efficiency

Using building materials, appliances or methods to reduce the amount of energy used by the homebuyer, thereby reducing 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.

Energy efficiency, the homeowner’s options

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).

energy audit

An inspection which pinpoints a home’s energy-efficient improvements and features in need of energy-efficient improvements.

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, §12.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).

Adding more **insulation** will, in most cases, reduce the energy bill. An energy audit will also identify where more insulation needs to be added.

home energy score

A rating system established by the Department of Energy quantifying the energy performance of a home.

1. Lighting

2. Sealing

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.

3. Insulation

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 it becoming an issue affecting the sales price before closing.*

California stays FiT, in some cities

Solar panel rebate and financing options

Chapter 24.1 Summary

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.

Chapter 24.1 Key Terms

building envelope	pg. 365
energy audit	pg. 364
energy efficiency	pg. 364
home energy score	pg. 365

A property's energy demands: an evolving factor in marketing

Chapter 24.2

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.

operating costs

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.

Learning Objectives

Key Term

The greener future is at hand

Energy efficiency is a public policy trend

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 main stream 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.

Solar on every new home’s roof

Beginning in 2020, California adopted new energy standards for newly built homes.

The new standards for **residential homes** and **multi-family buildings** of three-stories or less built beginning January 1, 2020 are:

- installing smart solar systems on rooftops (excepting some properties where shade makes this choice inappropriate);
- installing smart battery storage and heat pump systems that allow the home to store energy produced during off-peak periods;
- improving indoor air quality with high-efficiency air filters; and
- tightening the building envelope, including stronger insulation in attics, walls and windows.

For **nonresidential buildings** built beginning January 1, 2020, the new standards are:

- improving indoor air quality with high-efficiency air filters;
- installing LED lighting;
- installing motion sensors in bathrooms for lights; and
- requiring new healthcare facilities to adopt energy-efficient, nonresidential building standards (they were previously exempt).

The cost? The CEC estimates the new standards will increase the purchase price of new homes by about \$9,500. For homeowners, this translates to \$40 more a month due to a higher purchase price. But these costs will be offset by the average energy savings of \$80 a month, or a reduction of over 50% less energy than homes built under the old standards adopted in 2016.

While California is already struggling to fight its severe housing shortage, is it really the best time to be introducing yet more requirements that will lengthen the time and increase the cost of construction?

To stave off critics, California has kept open a few loopholes for builders who wish to circumvent the new solar requirements. For example, instead of installing solar, homebuilders may choose to buy into a solar credit system

which utilizes solar energy farmed at an off-site facility. This system still saves homeowners money, but less than half of the probable savings when each new home has its own solar system.

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.

California energy consumption

The influence of agents on energy efficiency

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.

What do buyers want?

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.

Strategies for making energy efficient improvements

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.

operating costs
The total annual cost projected to maintain and operate a property for one year. [See RPI Form 306]

Strategies when selling

	<i>Without Energy Improvements</i>	<i>With Energy Improvements</i>
<i>Home Price</i>	<i>\$150,000</i>	<i>\$154,816</i>
<i>Mortgage Amount</i>	<i>\$135,000</i>	<i>\$139,334</i>
<i>Monthly Payment</i>	<i>\$991</i>	<i>\$1,023</i>
<i>Energy Bills</i>	<i>\$186</i>	<i>\$93</i>
<i>Energy Bills + Monthly Payment</i>	<i>\$1,177</i>	<i>\$1,116</i>
<i>Monthly Savings</i>	<i>\$0</i>	<i>\$61</i>
<i>Savings over a ten-year period</i>	<i>\$0</i>	<i>\$7,320</i>

**Numbers from the Department of Housing and Urban Development (HUD's) Energy-Efficient. Mortgage Home Owner Guide.*

Figure 1
Sample Buyer
Operating Cost
Sheet

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, §12.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

**Listing
an energy
efficient
home**

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.

Comparing investments

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.

Making it easy

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?

Marketing the fixer-upper

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.

operating costs pg. 372

Chapter 24.2 Summary

Chapter 24.2 Key Term

Notes:

Factor 25: Regional housing indicators



Los Angeles County housing indicators

Chapter 25.1

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.

turnover rate

Los Angeles County home sales volume has decreased each year since 2018. In 2020, home sales volume declined 3% below 2019, translating to roughly 2,100 fewer sales over the course of the year. Still, given the pandemic and recession-induced slowdown mid-year, 2020's sales totals may have been much worse. However, record-low interest rates continued to prop up buyer interest, as well as home prices.

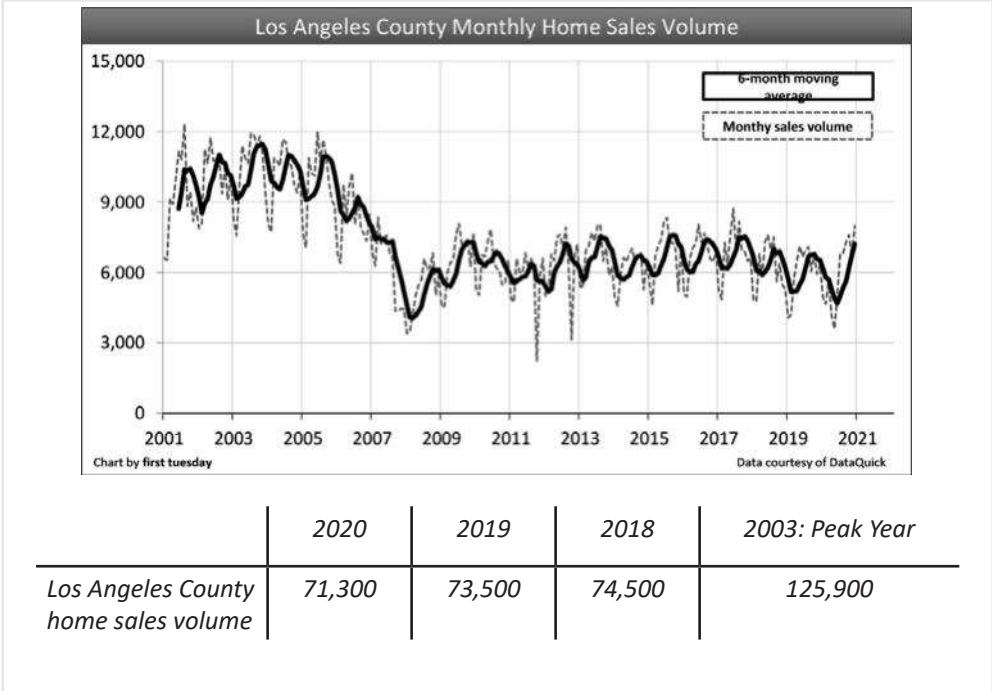
Learning Objectives

Key Term

A long, investor-driven recovery

Figure 1
Los Angeles County Monthly Home Sales Volume

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



Looking back, after **home sales volume** plummeted during the Great Recession of 2008, volume rose briefly in 2009 into early 2010, due primarily to the housing tax credit stimulus and a naturally recurring “dead-cat” bounce 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** (homebuyer occupants and long-term income property investors) for low-tier homes subsided, driven down by very rapidly rising prices and increased mortgage rates mid-2013.

A complete recovery of around 110,000 annual home sales will likely occur in the years following 2024, when end user demand in Los Angeles County will be buttressed by a Great Confluence of Baby Boomers and first-time homebuyers who are lured by an employment recovery. Residential construction starts will increase dramatically to fill buyer demand as cities within the county open up the permit process by a reduction in zoning restrictions in urban centers that will enlarge inventory counts.

turnover rate
 The percentage of households relocating each year, whether from rentals or ownership.

Turnover is down

Home sales volume depends in large part on homeowner and renter **turnover**. The number of people moving from their residence each year is indicative of both the willingness and ability of homeowners and renters to relocate. Turnover rates are highest when jobs are abundant, wages are rising, housing starts increase and employee confidence in the economy is high.

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 increased in the immediately following years, mostly due to turnover on foreclosures and short sales. The latest reports show LA homeowner turnover was relatively high as of 2018, with one in 16 homes selling annually. Still, this is below the peak year of 2005 when one in 12 homes sold each year.

With home prices running higher and average turnover dropping, expect homeowner turnover reports to slip dramatically in 2020. With 2020 recession job losses alongside COVID-19 eviction moratoriums, fewer renters and homeowners changed residences in 2020-2021.

The homeowner turnover rate will rise once home prices and interest rates align to produce desirable homebuying conditions. This is not expected before 2022-2023, when the additional and necessary factor of greatly increased residential construction will be experienced and a recovery from the 2020 recession will be underway.

This upturn will be fueled by a **Great Convergence** of first-time homebuyers (members of Generation Y forming households), retiring Boomers buying replacement homes and increased inventory generated primarily by construction starts, but short sales and REO resales will be in the mix. 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 is only slightly higher at 48.3% in Q4 2020. This is well below the 55% figure set at the height of the Boom. The rate will likely remain low until around 2023-2024 as rising FRM rates and faltering prices in the interim drive many owners into negative equity with attendant short sales and foreclosures creating a wait-and-see attitude among buyers.

LA County's homeownership rate has historically been lower than the state average, which was 55.6% in Q4 2020. 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 right around 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. Like in other regions, there was a small bump in prices in 2009 driven by various state and federal **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.

Homeownership bottoms

The rise and fall of home pricing

Figure 2

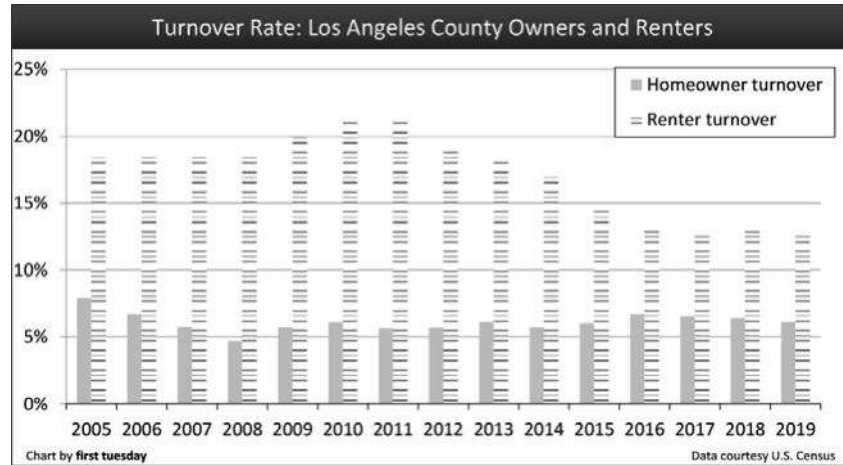
**Turnover Rate:
Los Angeles
County Owners
and Renters**

and

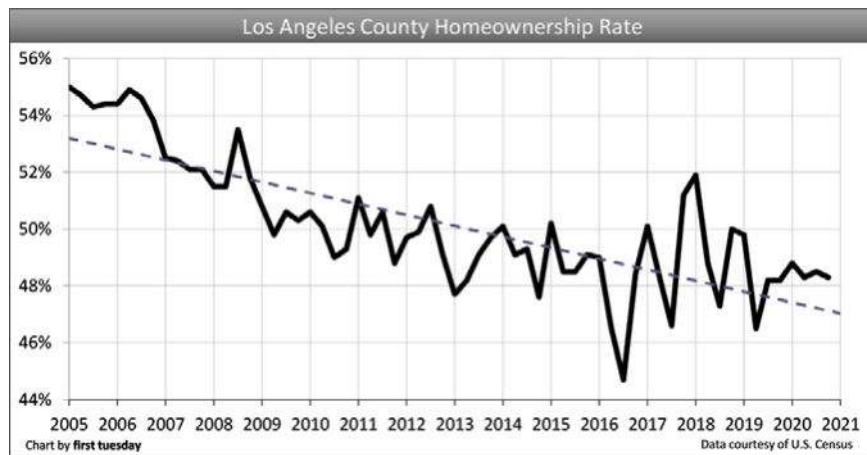
**Los Angeles
County
Homeownership
Rate**



ONLINE UPDATE
Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



	2018	2017	2016
LA County homeowner turnover rate	5.4%	5.7%	6.7%
LA County renter turnover rate	12.9%	12.9%	13.5%



	Q4 2020	Q3 2020	Q4 2019
LA County homeownership rate	48.3%	48.5%	48.2%

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, increasing about 6% each year.

Accurate home price reports run about two months behind current events. Even when caught up, **sticky prices** tend to persist several months beyond the moment when home sales volume begins to slow. Starting in March 2020,

economic volatility and shelter-in-place orders caused home sales volume to decline dramatically. However, historically **low interest rates** provided a boost for buyer purchasing power, which, along with low inventory, propped up home prices in 2020.

In 2021, the economic recession will finally take its toll on home prices, placing downward pressure on pricing with the removal of support provided by economic stimulus. The overall home price trend for the next couple of years will be down, the result of historic job losses and rising 90+ day mortgage delinquencies, which will lead to a wave of distressed sales when the foreclosure moratorium lifts in 2021. As during the 2008 recession, the drop in sales volume and prices will first be most volatile on the coast, before rippling outward to inland areas.

Multi-family construction starts jumped significantly in Los Angeles County at the outset of the recovery, 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, the City of Los Angeles is accommodating and lenders are catching on.

However, the multi-family recovery has ended in 2020, falling dramatically in the second half of the year. This steep decline is partly the result of shelter-inplace orders in response to the COVID-19 pandemic, and also due to cautious lenders and builders. However, significant gains experienced earlier in the year resulted in an overall annual increase in construction over the previous year.

The next peak in SFR construction starts will likely occur in 2023-2024 period due to a boost from state legislation. Even then, SFR starts will not return to the mortgage-driven peak experienced during the Millennium Boom. However, multi-family housing starts in the 2023-2024 upturn will experience higher levels as 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 — Millennials — before they turn away from renting and become homeowners as they age, no differently than did the Baby Boomers in the early 1990s.

Since homeowners and renters require employment to make **housing payments** (with rare exception), the jobs recovery is key to the housing recovery. Just over 4.2 million people are employed in Los Angeles County as of December 2020. This is 419,900 fewer jobs than at the December 2019 peak reached a year earlier.

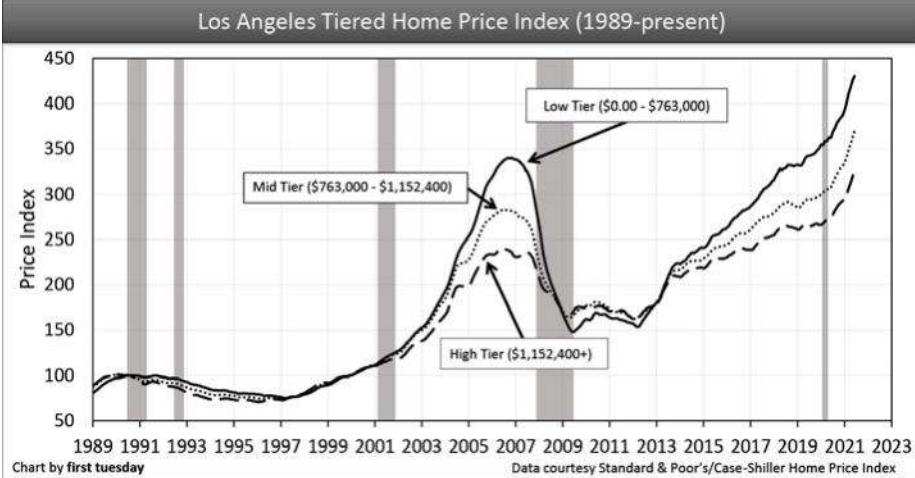
From the December 2019 peak to the trough in April 2020, Los Angeles lost 738,000 jobs. Since then, jobs have increased marginally as some social distancing measures have loosened. However, at the end of 2020, the number of jobs held in Los Angeles is 9.0% below a year earlier. This is roughly the same

Construction starts feed on rental demand

More jobs needed

Figure 3
Los Angeles Tiered Home Pricing 1989-Present
and
Los Angeles County Monthly Construction Starts

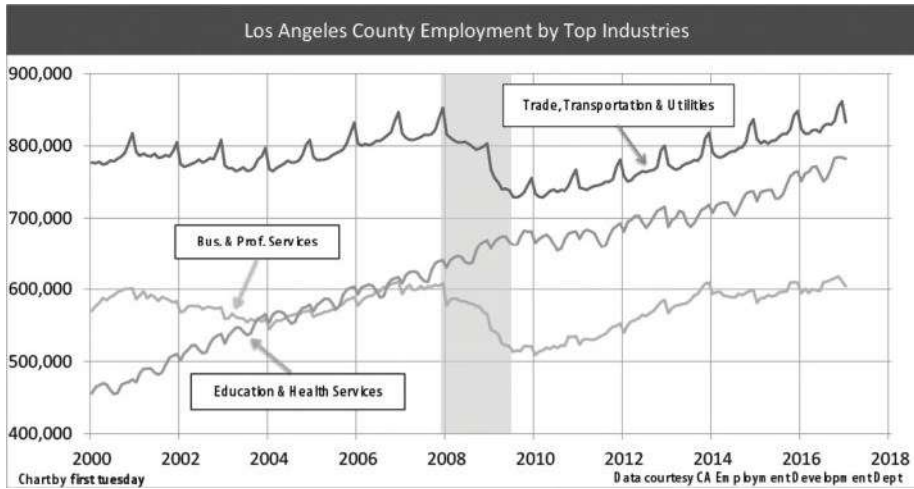

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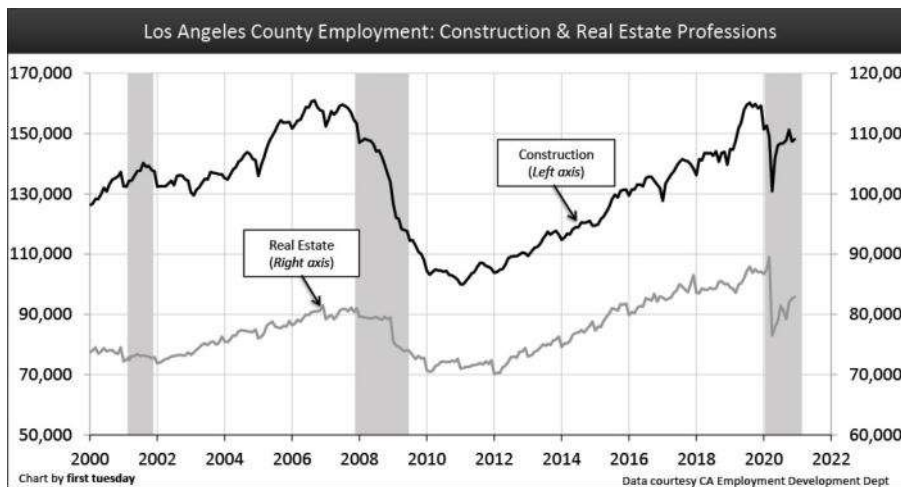
	Low-tier annual change	Mid-tier annual change	High-tier annual change
LA County Home Price Index: Q4 2020	+10%	+11%	+10%



	2020	2019	2018
Los Angeles County single family residential (SFR) starts	8,000	5,700	6,100
Los Angeles County multi-family starts	18,400	15,900	16,500



	Dec 2020	Dec 2019	Annual change
Los Angeles County employment	4,234,900	4,654,000	-9.0%




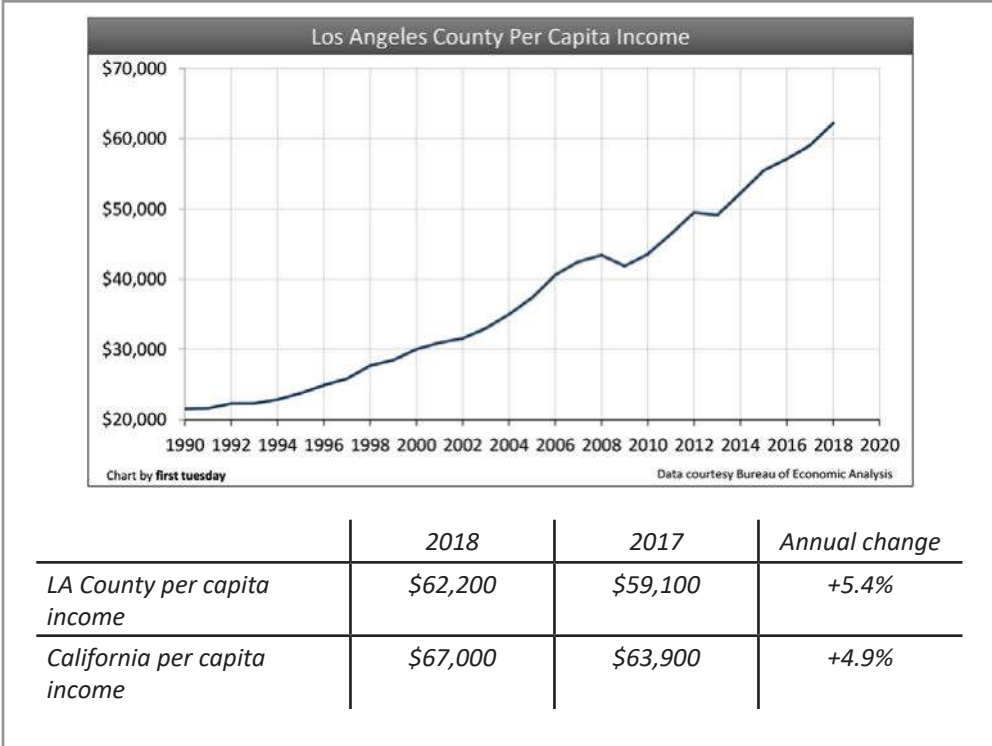
	Dec 2020	Dec 2019	Annual change
LA County construction jobs	148,100	159,200	-7.0%
LA County real estate jobs	82,900	87,100	-4.8%

Figure 4
Los Angeles County Employment by Top Industries
 and
Los Angeles County Employment: Construction & Real Estate

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Figure 5
Los Angeles County Per Capita Income


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level of job loss experienced statewide, which is 8.0% below a year earlier as of December 2020. Expect a W-shaped recession in the coming months, with jobs rising and falling, not to enter a true recovery until around 2023-2024.

In the housing industry, construction jobs have gradually regained numbers over the past decade of recovery from the 2008 recession, reaching a full recovery just before the job losses of the 2020 recession. Likewise, the number of employed real estate professionals was recovered gradually, cresting pre-2000 recession levels in 2016 and rising.

In 2020, both industries have experienced a hit to job numbers, resulting in thousands of lost jobs. While construction will bounce back fairly quickly due to the unmet demand for housing, real estate professionals will see a slower rebound as they contend with reduced transactions and, in the coming months, lower home prices. The real estate profession will not likely experience a sustained increase until the next confluence of buyers and renters (members of the **Generation Y** and **Baby Boomer** generations) converge on the market in the years following 2023.

Everyone needs income to buy or rent

The average income earner in Los Angeles County earned roughly \$62,200 in 2018 (the most recently reported Census year). For perspective, this figure is just slightly below the statewide per capita income.

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 homeless or relocation symptoms.

Los Angeles County, hit hard by the 2008 recession, never returned to Millennium Boom levels in terms of home sales volume and construction. LA recovered the number of jobs lost during the recession at the end of 2014, reaching a full recovery when counting population gain in 2019, just in time for the next recession to hit in February 2020.

The long home sales volume recovery in Los Angeles County was driven primarily by investors. But the housing market began to show more life from owner-occupants as employment and incomes improved beginning in 2017. Then, as buyer-occupants fought against rising mortgage rates, they became more cautious, causing sales volume to fall in 2018-2019.

In 2020, interest rates plunged to historic lows. But low interest rates haven't been enough to induce sellers who are unable or unwilling to list in light of the job losses stemming from the coronavirus (COVID-19) pandemic, along with the underlying recession. This has resulted in a strangled MLS inventory, accelerating prices to unsustainable heights. As the impacts of the 2020 recession continue to reverberate throughout the jobs and housing markets, expect to see home sales volume level off and decline, not to begin a consistent recovery until 2023-2024. Today's rising home prices will be brought down by the end of the foreclosure moratorium in 2021, which is currently keeping over 5% of California's mortgaged homeowners in their homes, despite being delinquent on their mortgages.

turnover rate pg. 378

Chapter 25.1 Summary

Chapter 25.1 Key Term

Chapter 25.2

Orange County housing indicators

Learning Objectives

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.

The recovery that never occurred

Home sales volume in **Orange County** remains weak and somewhat stuck at just over half the heights seen during the Millennium Boom. Echoing state trends, Orange County saw a decrease in total home sales volume in 2018, ending the year 9% lower than in 2017. In 2019, home sales volume was a further 3% below 2018. In 2020, home sales volume reversed course, rising a slight 3% above the prior year.

A sharp rise in home pricing here and across the state has held sales volume back from any significant increases. Buyers' incomes have been insufficient to keep up with quickly rising home prices. However, buyer purchasing power received a boost in 2020 when mortgage interest rates fell to historic lows, inducing prices to rise even quicker despite the recessionary environment.

Government stimulus efforts continue to inject support into the housing market, but once that support ends, it's questionable whether OC's market will be able to support itself. Following the 2008 recession, 2009-2010 Orange County sales volume rose slightly with the introduction of the housing tax credit (government stimulus), only to fall 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. Expect to see similar action across the state in 2022-2024.

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 in the 2023-2024 recovery period following the 2020-2021 recession.

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, at 7.3% in 2018. The **renter turnover rate** has declined since 2010 and was at 19.5% in 2018, the most recently reported Census year.

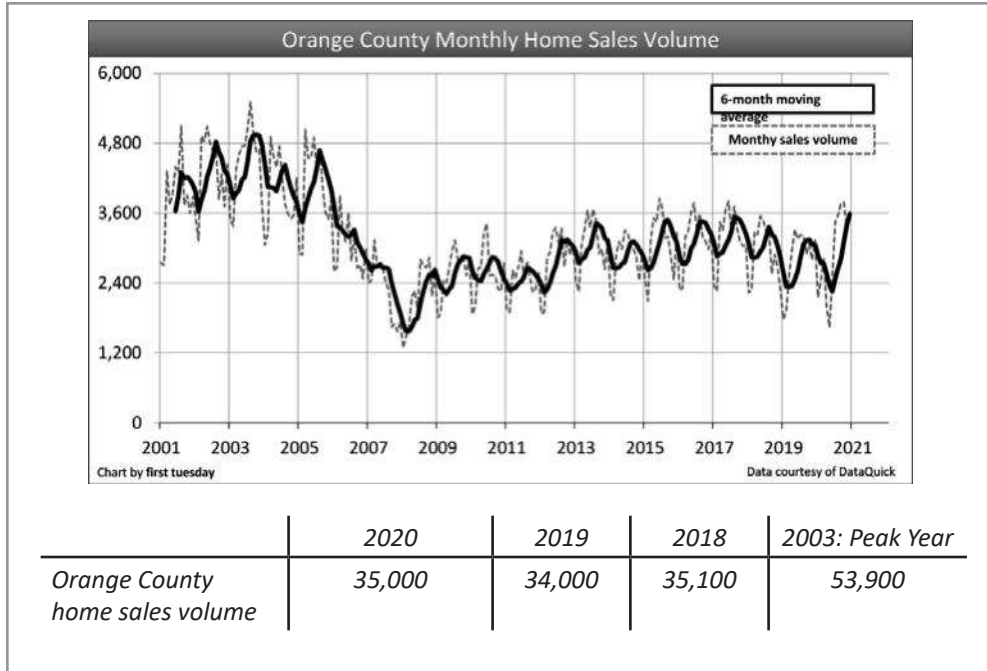


Figure 6
Orange County Monthly Home Sales Volume

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Expect turnover reports to fall in 2020. With 2020 recession job losses alongside COVID-19 eviction and foreclosure moratoriums, significantly fewer renters and homeowners are currently changing residences.

The homeowner turnover rate will rise once home prices and interest rates align to produce desirable homebuying conditions. This is not expected before 2023, when the additional and necessary factor of increased residential construction will be experienced a recovery from the 2020 recession will be imminent. 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 57.4% homeownership rate in Orange County. Statewide homeownership has historically been about two percentage points below Orange County's. The state average is currently 55%, thus homeownership reports in Orange County in 2017 will likely remain around 57%.

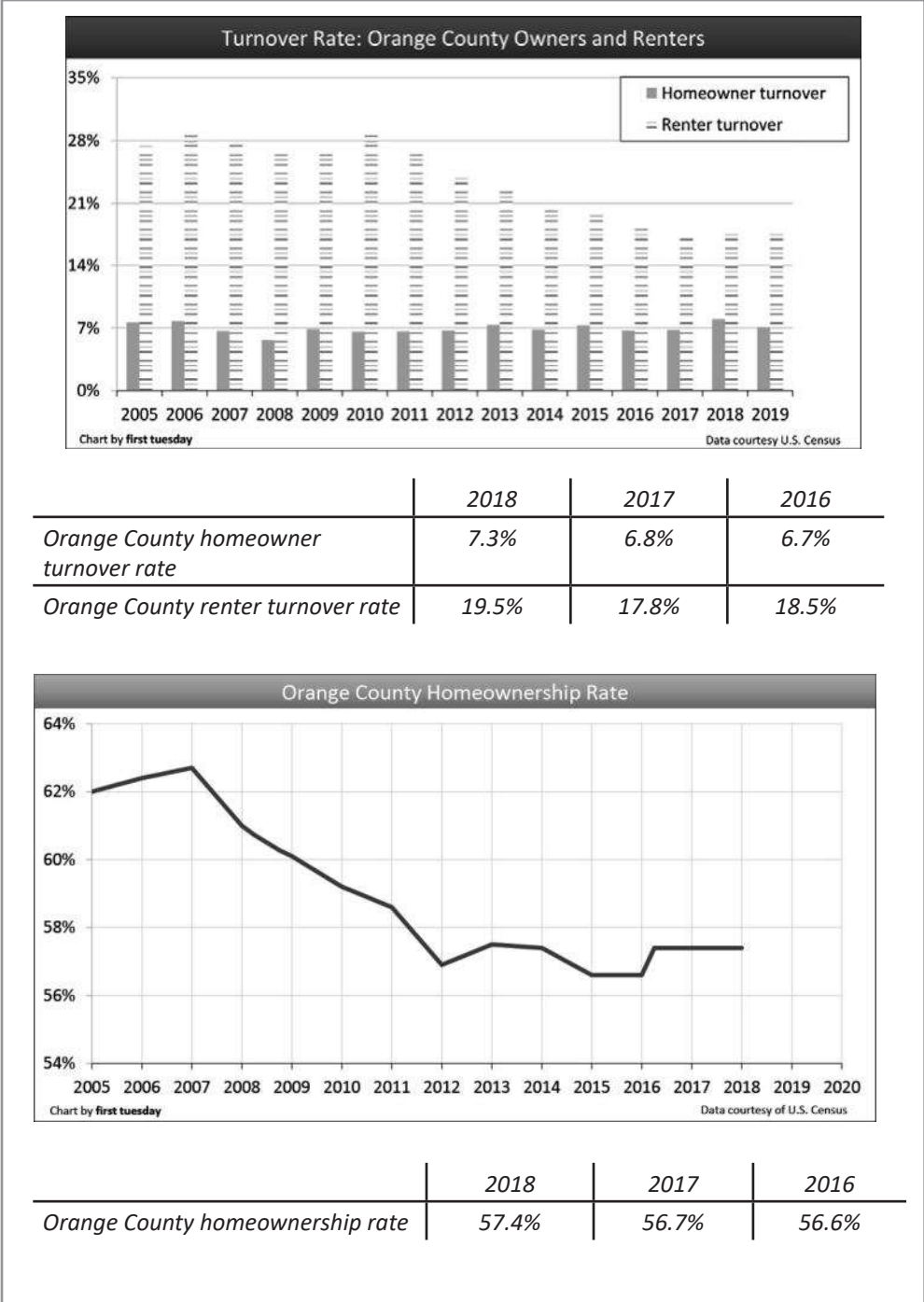
Homeownership remains low

Expect Orange County's homeownership rate to remain at its present low level until 2023-2024, when the housing market will bounce back from the 2020-2021 recession. Only with the return of jobs, higher wages and increased confidence 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

Figure 7
Turnover Rate:
Orange County
Owners and
Renters
and
Orange County
Homeownership
Rate


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certain destabilizing types of mortgage lending. These rules limit mortgage funding to those homebuyers with the financial ability to actually repay their debts.

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.

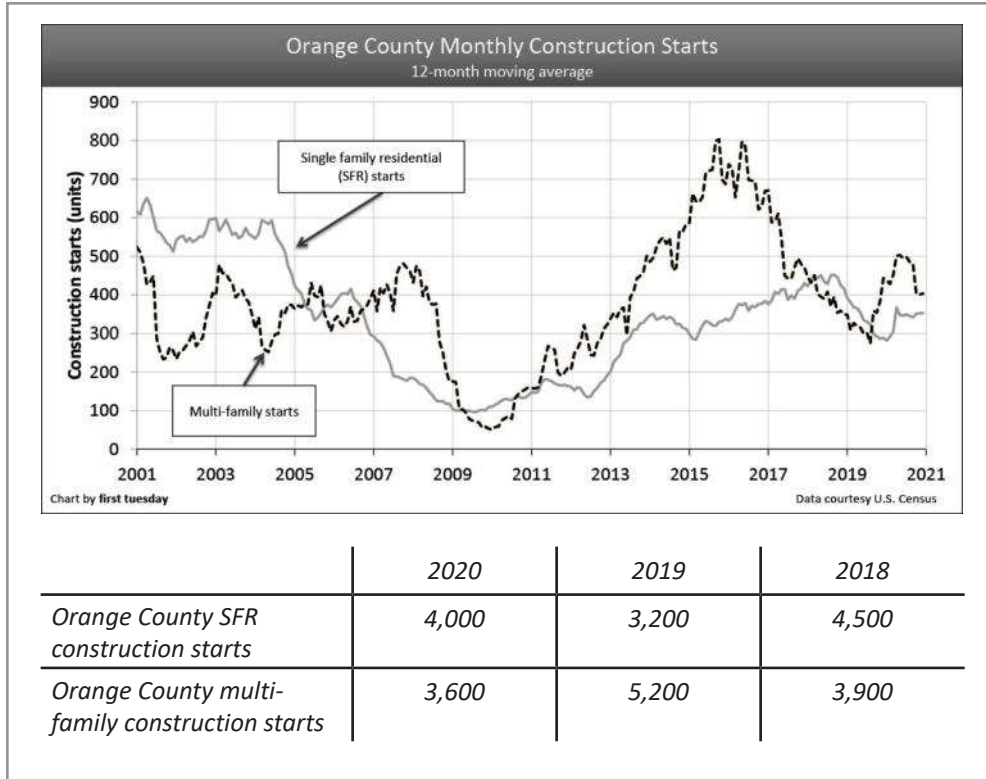


Figure 8
Orange County Monthly Construction Starts

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The recovery picture is mixed for Orange County residential construction. After years of increased single family residential (SFR) construction starts, 2018 and 2019 both saw a decrease in the number of new SFRs started. In 2020, the trend reversed, with SFR construction rising and multi-family declining.

Multi-family starts in Orange County totaled just 3,600 in 2020, down 31% from 2019. This decline resumes a long downward trend that was broken briefly in 2019. However, statewide legislative moves focused on adding more housing for the ever-growing resident population will push more multi-family construction in the coming years.

2020's slowing construction starts were partly the result of shelter-in-place orders in response to the COVID-19 pandemic and decreased confidence in the economy from lenders and builders.


California regained all jobs lost to the 2008 recession at the end of 2014, but Orange County didn't catch up until the last quarter of 2015. Since then, jobs have struggled to gain traction in Orange County. The number of employed individuals here is 8.4% below a year earlier as of December 2020, amounting to a loss of 142,700 jobs compared to before the 2020 recession.

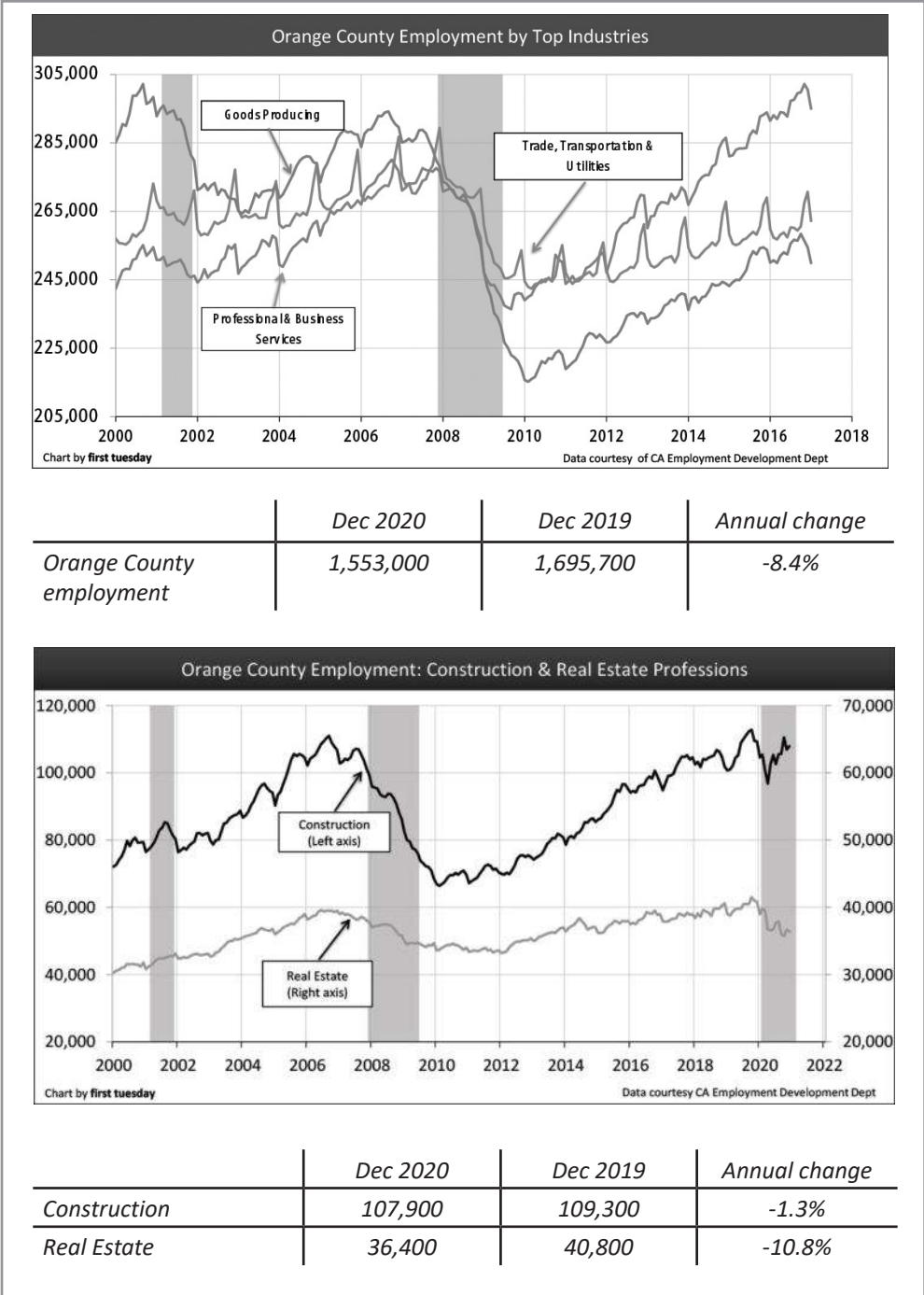
As seen in Figure 9, job additions have been one-third slower to come about during this recovery compared to the 2000s recovery, and at half the pace of the 1990s recovery, echoing the **secular stagnation** of the 1930s. When will all of these jobs catch up with Orange County's continuously growing population?

Construction starts on the rebound

Jobs are recovering, too slowly

Figure 9
Orange County Employment by Top Industries
and
Orange County Employment: Construction & Real Estate Professions


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When counting population growth, Orange County was on course to return to pre-recession levels in 2020, but not before the 2020 recession arrived, causing significant job losses in the region. The share of jobs lost here is worse than the job loss experienced statewide, which is 8.0% below a year earlier as of December 2020. Expect a W-shaped recession in the coming months, with jobs rising and falling, not to enter a true recovery until around 2023-2024.

The number of individuals employed in the real estate and construction industries fell dramatically during the 2008 recession, beginning to show

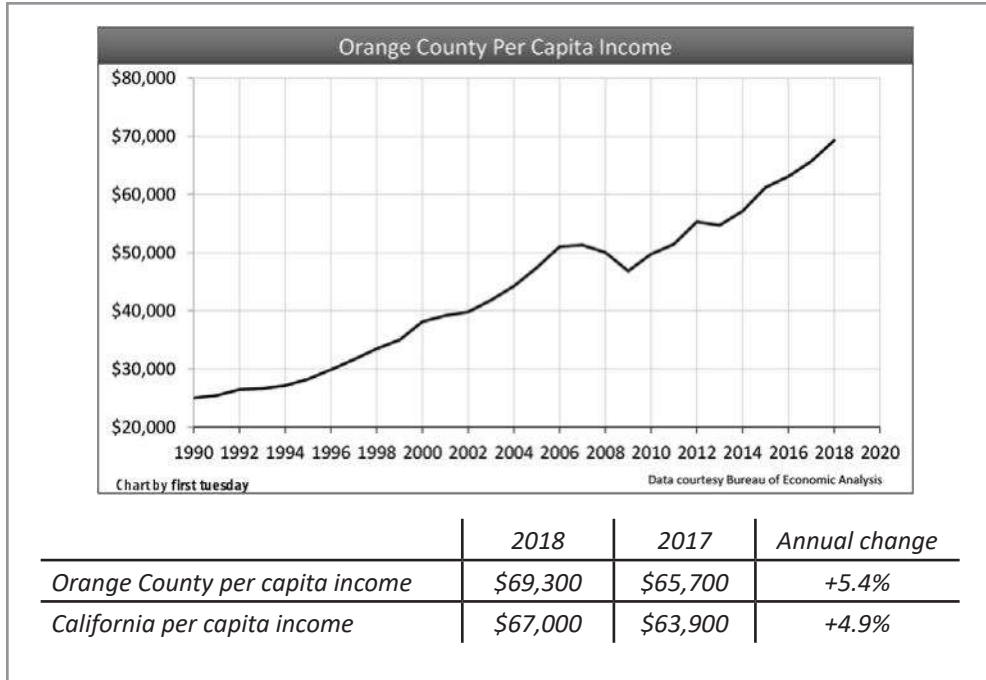


Figure 10
Orange County Per Capita Income

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mixed improvement beginning in 2012. While the number of real estate professionals is now level with pre-2008 recession levels, construction workers are still well below their Millennium Boom peak, and declining going into 2021. Job numbers have already begun to recover in the construction industry, but the number of real estate professionals continues to decline as sales volume slows and a steady flow of agent fees becomes increasingly less reliable.

Construction jobs will likely continue to rise over the long term, as state legislation focused on adding more housing inventory is not impacted by the recession. The real estate industry will see jobs increase beginning in 2023-2024 with the recovery from the 2020-2021 recession.

The average income earner in Orange County made \$69,300 in 2018 (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 2017 to 2018 in this region being 5.4%. Anything beyond this rate of income increase is ultimately unsustainable. As the significant job losses continue in 2021, expect home values to soon feel the hit, too.

In 2022-2023, prices will feel downward pressure 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. This income was briefly inflated due to record-low interest rates in 2020, but as rates rise, homebuyer purchasing power – and home prices – will fall.

Per capita income plays catch up

Chapter 25.2 Summary

As we make our way through the ongoing 2020 recession, it's important to note that Orange County's housing market never fully recovered from the 2008 recession. Home sales volume remained low throughout the elongated recovery of the 2010's, as did job creation. Residential construction of all types continues to struggle in this region, leaving would-be homebuyers wanting for more.

As the 2020 recession maintains its grip on the economy, proactive agents will prepare for the slowdown in sales to linger here in Orange County and across the state. Job losses stemming from the coronavirus (COVID-19) pandemic, along with reduced MLS inventory, have held down sales volume. Prices have continued to rise due to the current supply-and-demand imbalance, propped up by record-low interest rates. But this brief boost will not last as the impacts from the recession linger in the months ahead and the end of the foreclosure moratorium injects distressed sales into the MLS inventory. Expect prices to decline heading into 2022, bottoming in 2022 before the next recovery will begin around 2024.

Riverside County housing indicators

Chapter 25.3

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.

Learning Objectives

Home sales volume in **Riverside County** has remained mostly 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 2020 and a true recovery still has not materialized, as annual sales volume continues to plod along.

Suburban demand grows the housing market

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 and remaining roughly level since.


Home sales volume will recover from the 2020-2021 recession around 2023-2024, at which point first-time Generation Y (Gen Y) and Gen Z homebuyers and Baby Boomer retirees will converge to drive up sales volume and prices. In the meantime, expect home sales volume to taper off and prices to follow in 2022.

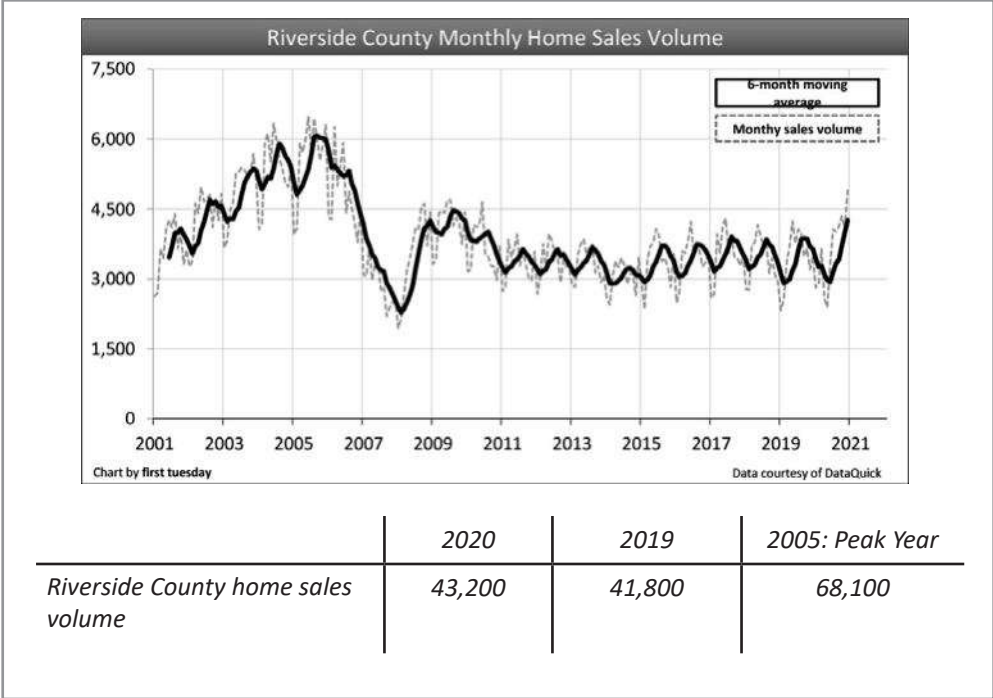
Without homeowner or renter **turnover**, homes do not sell. In Riverside, the number of homeowners and renters moving in recent years peaked in 2009 due to the tax stimulus and high level of foreclosures, which temporarily lifted sales volume as tenants became homeowners. In a reversal, turnover has swiftly declined since then as potential end users have chosen more often to remain where they are.

Turnover falls

The *renter annual turnover rate* fell from above 26% in 2013 to just below 17.3% in 2018 (the most recently reported Census year). On the other hand, the

Figure 11
Riverside County Monthly Home Sales Volume


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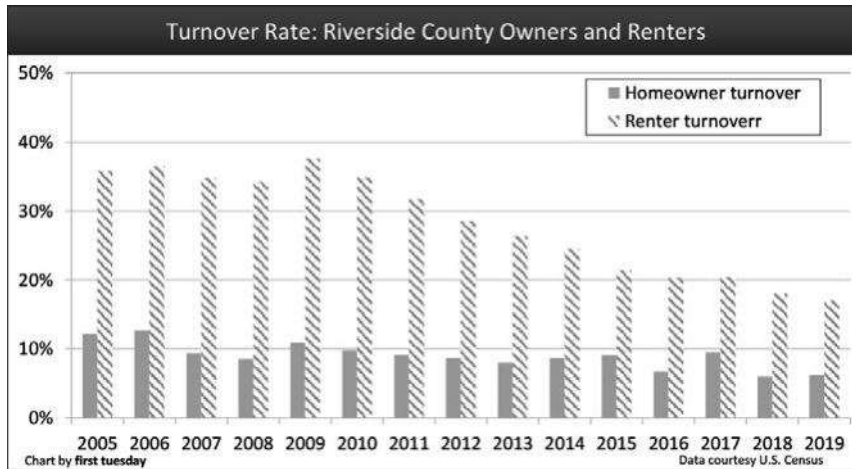
homeowner turnover rate rose significantly in 2017 to 9.5%, its highest level since 2009. It has since fallen back slightly, to 8.3% as of 2018. Homeowner turnover is still below the level needed for a full recovery in home sales volume.

When job growth and wages stagnate, residents lack the *confidence* (and more importantly, often the financial ability) to move. When significant job losses occur, such as during the **2020-2021 recession**, turnover plummets. 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.

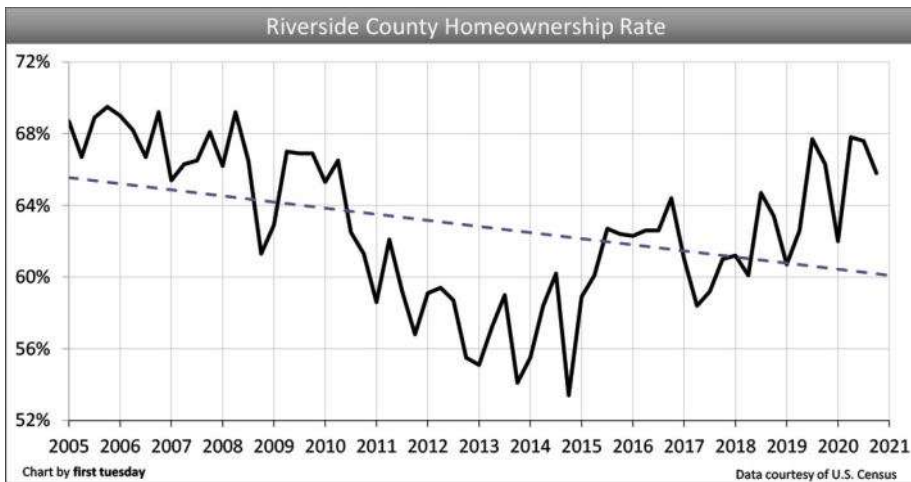
Turnover rates are likely to slow across the state in 2020-2022, much like they did following the 2008 recession. After this brief dip in economic activity, members of *Gen Y* who have remained employed will be more eager to rush from their apartments to buy and *Baby Boomers* will begin to retire in larger numbers, generally buying smaller, more convenient replacement homes after they sell. 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.

Homeownership rate bounces back

Riverside County’s **homeownership rate** fell steeply during the recession but has since clawed its way back to just below Millennium Boom levels. Riverside’s rate of homeownership hovered around 68% from 2000 through the end of the Millennium Boom. As of Q4 2020, the homeownership rate is just below 66%. This is significantly higher than the state average, which is 55.6% in Q4 2020.




	2018	2017	2016
Riverside County homeowner turnover rate	8.3%	9.5%	6.7%
Riverside County renter turnover rate	17.3%	18.8%	20.3%




	Q4 2020	Q3 2020	Q4 2019
Riverside County homeownership rate	65.8%	67.6%	66.3%

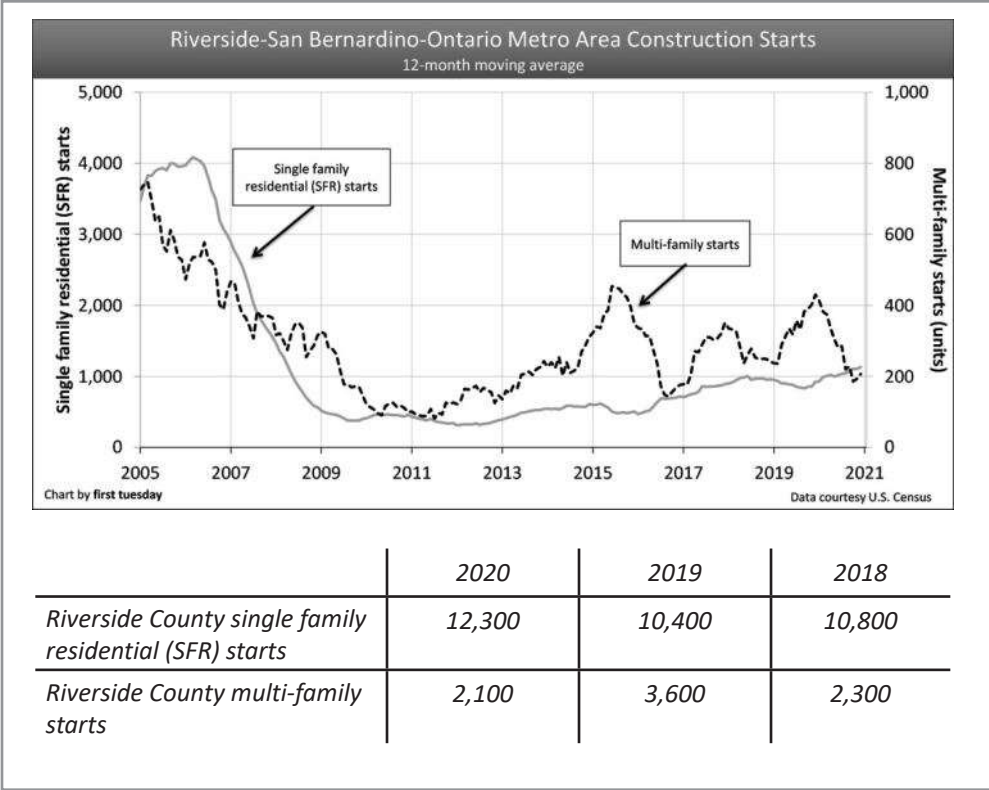
Figure 12
Turnover Rate: Riverside County Owners and Renters
and
Riverside County Homeownership Rate


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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 later in 2019, just in time for the economy to head into its next slump. When the 2020-2021 foreclosure moratorium expires and jobless

Figure 13
Riverside-San Bernardino-Ontario Metro Area Construction Starts


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homeowners behind on their payments begin to head toward foreclosure, the homeownership rate will gradually fall back below pre-recession levels in 2022-2023, to rise in the following recovery.

Residential construction mixed

Residential construction starts are recovering marginally in the Riverside Metropolitan area. During the current housing cycle, multi-family starts recently peaked in 2015. Since then, they have fluctuated each year, declining significantly in 2020.

Here, the focus on multi-family construction is far less pronounced than in regions closer to the coast, as the lower cost of land keeps single family residences (SFRs) within reach of more households. Meanwhile, SFR starts are rising gradually.

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.

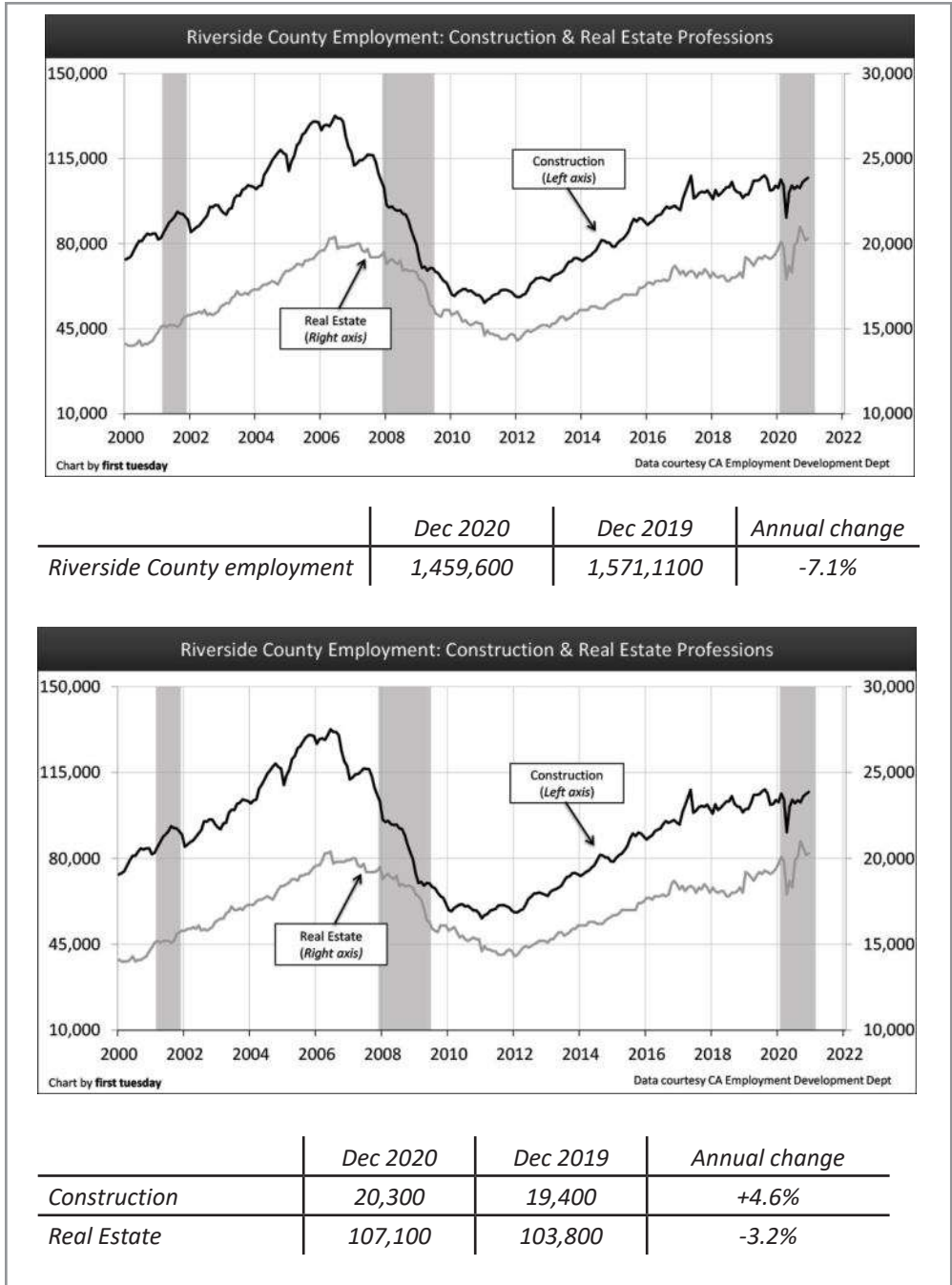


Figure 14
Riverside County Payroll Employment and Riverside County Employment: Construction & Real Estate Professions


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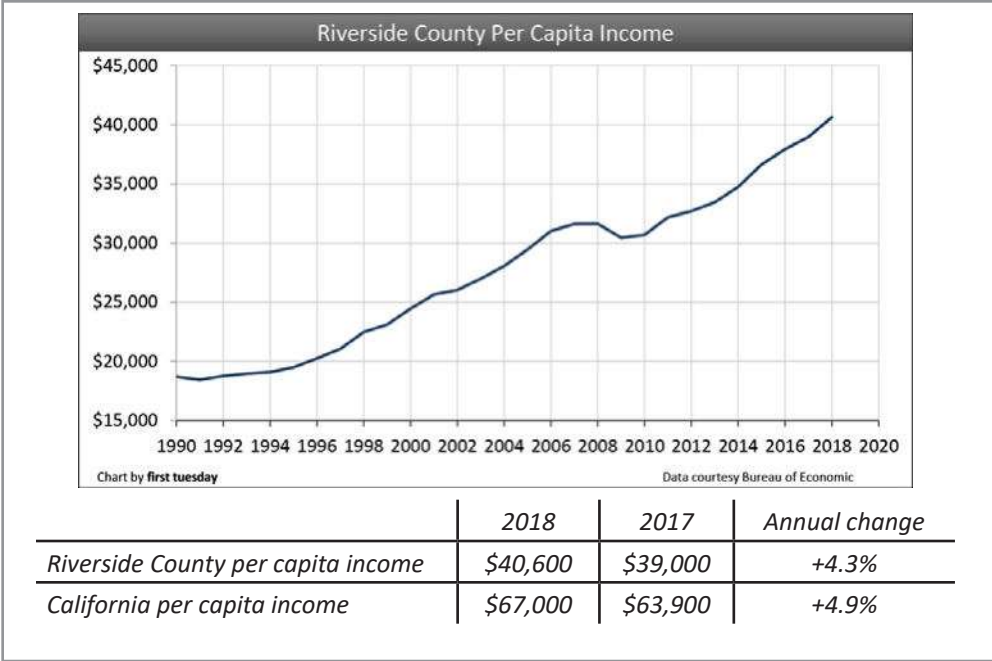
The next peak in SFR construction starts will likely occur in 2023-2024 due to legislative efforts to increase California’s housing stock. Even then, SFR construction starts are very unlikely to return to the mortgage-driven numbers seen during the bacchanalia of the Millennium Boom.

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.

Jobs are picking up

Figure 15
Riverside County Per Capita Income


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The number of individuals employed in Riverside County finally surpassed its December 2007 peak in Q4 2014. As of December 2020, 111,500 fewer individuals are employed than at the outset of the 2020 recession. Expect the number of employed to waver in 2021-2022 as the economy continues to struggle, mostly dependent on support from government stimulus. It will take another one-to-two years before a consistent jobs recovery begins to adequately support further home price increases.

While Riverside’s real estate and construction industries have yet to recover from the 2008 recession, the 2020 recession has thus far been less hard on these industries compared to other parts of Southern California.

The number employed in the construction industry decreased 3.2% during 2020 in Riverside. However, the number of individuals employed in the real estate industry was 4.6% higher than the previous year. Expect the number of real estate professionals fully employed to see a decline in the coming years, the result of sluggish sales volume and less stable prices in 2022-2023. Construction workers will be somewhat shielded from today’s recessionary impacts, as, unlike during the lead-up to the 2008 recession, overbuilding has not been a problem in recent years. In fact, Riverside is in need of significantly more residential construction to keep up with demand from its rising population. State-initiated legislation will likely continue to propel construction even during the leaner years ahead.

Per capita income points to a slow recovery

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.

The average employed individual in Riverside earns just \$40,600, according to the most recent Census reported year of 2018. The statewide average income is much higher than Riverside's. However, the average resident of Riverside spends less of their income on housing expenses than those living in urban coastal cities.

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 concurrently with increases in job numbers and the competition that brings employer demand for more employees.

Riverside is the fourth most populous county in California with over 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.

But the recession left the region with deep losses in home sales volume, construction starts and employment. A decade after the end of the 2008-2009 recession, Riverside's economy has remained in a state of prolonged recovery during the prior decade, slowly gaining momentum as lost jobs are regained. Employment finally exceeded the number of jobs prior to the Great Recession at the end of 2014, barely catching up with the population gain following 2008 before the 2020 recession hit and more jobs were lost.

Local sales agents can expect sales volume to level off and decline as Riverside residents continue to grapple with the hangover from the 2020 recession. Historically low interest rates and a shortage of sellers willing to list have thus far inflated home prices. But steep job losses resulting from the global pandemic response and 2020 recession have meant many homeowners — estimated at over 5% of mortgaged homeowners — are now delinquent on their mortgages. When the foreclosure moratorium expires going into 2021, expect to see a jump in distressed sales, saturating the market and bringing down home prices. As with other economic activity, look for the next recovery to ripple out from the coasts, beginning for Riverside around 2024.

Chapter 25.3 Summary

Chapter 25.4

Sacramento County housing indicators

Learning Objectives

After reading this chapter, you will be able to:

- understand how Sacramento's reliance on state and local government jobs has held back the local jobs recovery; and
- forecast the next boom for local construction and home sales.

Government jobs support the housing recovery

After years of consistent growth, **home sales volume** in Sacramento County remained essentially flat in 2018-2019. In 2020, annual home sales totaled 1.5% below 2019.

Sacramento's decline in sales volume has not been as steep as many other parts of the state. One reason why home sales volume has fared better is the consistent addition to the **for-sale inventory**, in the form of residential construction. In California's expensive and desirable coastal cities, new construction has been held back significantly by outdated zoning laws and not-in-my-backyard (NIMBY) advocates. Not so in Sacramento, where construction is welcome and allows sales volume to keep pace with **homebuyer demand**.

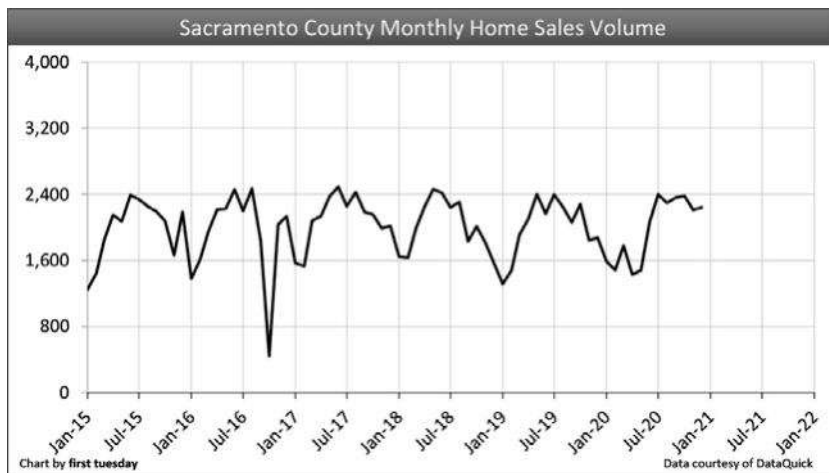
Even so, home sales volume is expected to slow further in 2021, primarily due to the continued impacts of historic job losses in 2020. The uncertainty stemming from the recessionary jobs market will keep many would-be sellers on the sidelines in 2021-2022, and most will not return until the market has worked through the coming wave of distressed sales.

Homeownership peaks

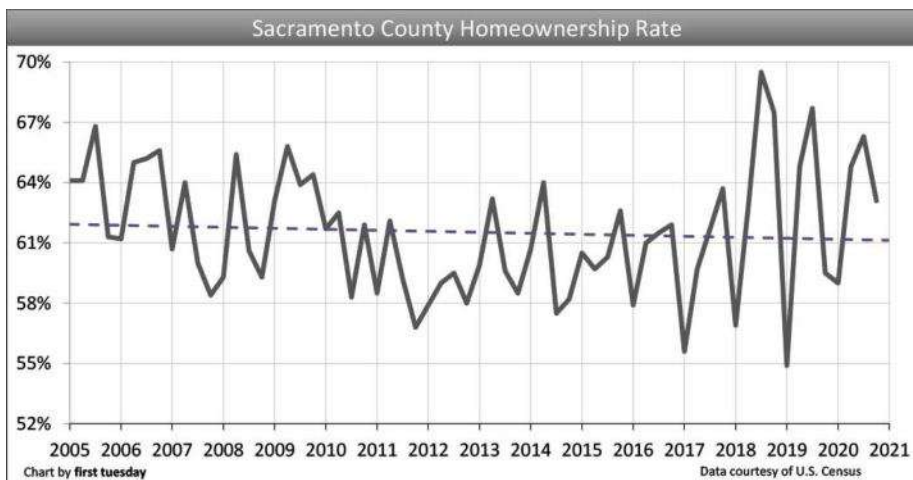
The **homeownership rate** in Sacramento County varies greatly each quarter, though the general trend was flat-to-down for over a decade — until homeownership began to jump dramatically in 2017. As of Q4 2020, the homeownership rate here is just above 63%. For comparison, the statewide average was a much lower 55.6% at the end of 2020.

The homeownership rate's previous peak was 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. Many buyer-occupants have returned to the market since then.

The higher homeownership rate in 2020 is unstable, unable to be supported by market fundamentals. Expect Sacramento's homeownership rate to fall




	2020	2019	2018
Sacramento County Home Sales Volume	23,700	24,100	24,200



	Q4 2020	Q3 2020	Q4 2019
Sacramento County homeownership	63.1%	66.3%	59.5%

Figure 16
Sacramento County Monthly Home Sales Volume
 and
Sacramento County Homeownership Rate



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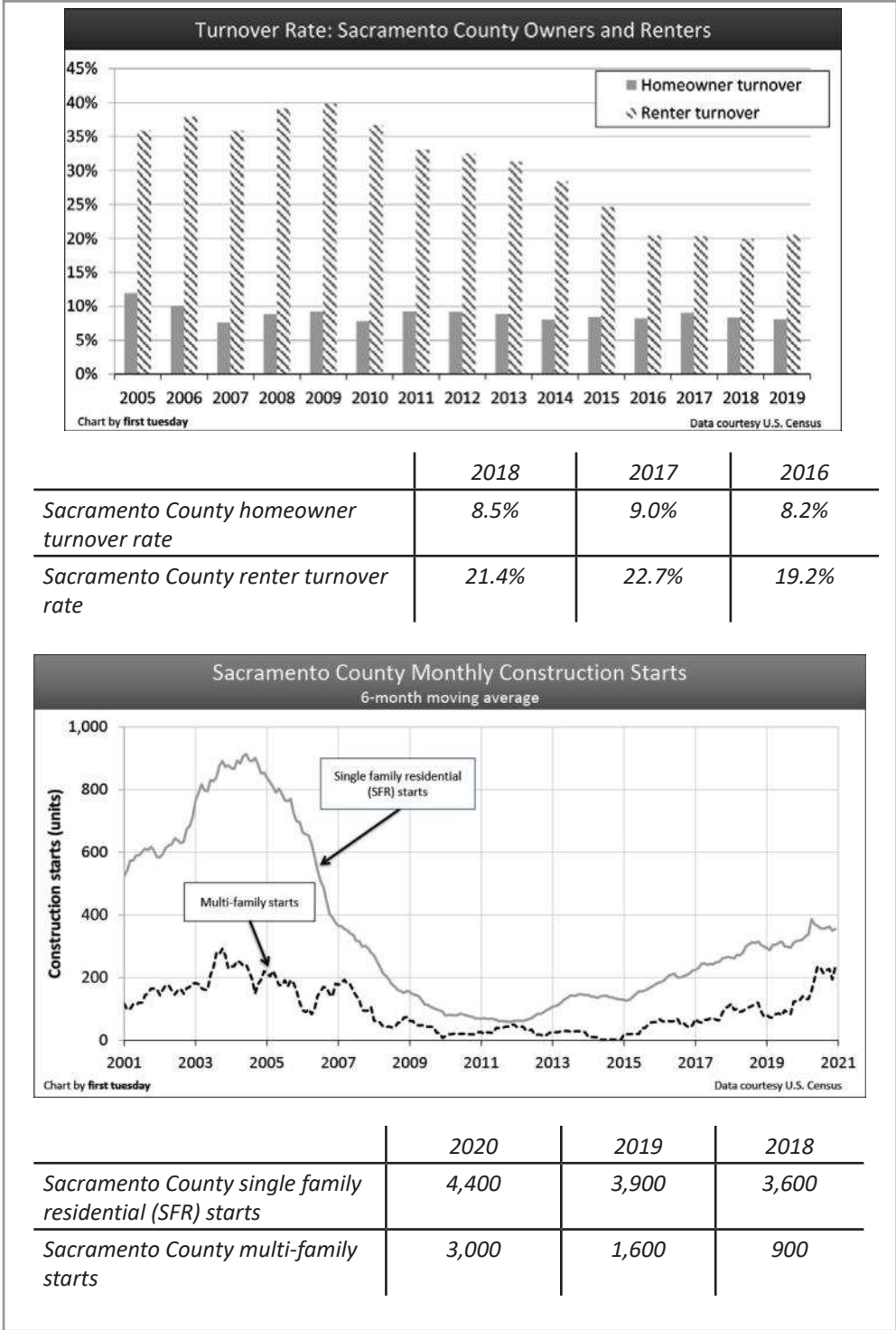
back in 2021-2022, as negative economic conditions discourage homebuyers. Owner-occupants won't return in solid numbers until Sacramento's jobs market has a chance to fully recover from the 2020-2021 recession, likely in the post-recession years of 2023-2024.

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.

Turnover flat to down

Figure 17
Turnover Rate:
Sacramento
County Owners
and Renters
and
Sacramento
County Monthly
Construction
Starts


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The good news is, after years of falling, **owner-occupant** turnover has recently leveled off according to the most recent U.S. 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 8% each year, at 8.5% in 2018.

On the other hand, the general trend for **renter turnover** is down, though more renters moved in 2017 than 2016. 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, rebounding in 2017 to over 22% and falling back to 21.4% in 2018.

Like the homeownership rate, expect to see reports for homeowner turnover decrease in 2020-2021. Then, with the support of a healthy jobs market in the years following the next recovery, turnover will gradually improve.

After years of flat performance, construction in Sacramento County began to make solid gains in 2020. In the past couple of years, there have been several months where builders started *zero* new multi-family or single family residential (SFR) construction projects. This dormant situation saw an injection of new growth in 2020, as investors set their eyes on Sacramento as a city primed for residential growth.

However, even the current level of construction is below what Sacramento needs to keep up with demand from homebuyers and renters alike. In fact, the peak year of 2003 saw nearly *three times* more SFR construction starts than the 4,400 SFR starts experienced in 2020. Further, **multi-family construction** is finally looking up, with 2020 surpassing the peak year for construction last achieved during the Millennium Boom.

Construction is likely to continue to outpace the rest of the state in the years following the 2020-2021 recession. State legislative efforts to increase the low- and mid-tier housing stock have focused on encouraging more multi-family construction, and with Sacramento's relatively low cost of living compared to other Central and Northern California metros, it has become an attractive city for many first-time homebuyers and renters looking to save and still maintain a high standard of living.

Sacramento was one of the last counties in California to reach a pre-2008 recession jobs recovery. Its lagging recovery can be attributed partially to Sacramento's dependence on *state and local government jobs*, which were slow to return.

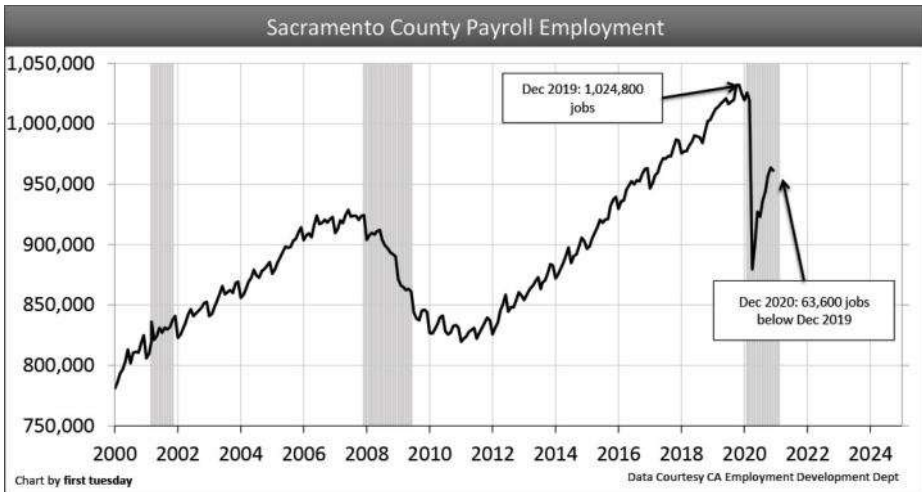
Further, Sacramento's population has grown about 1% each year since the 2008 recession. With working-aged individuals making up some 60% of this added population, Sacramento needed an additional 84,000 jobs for adequate

Construction has stalled

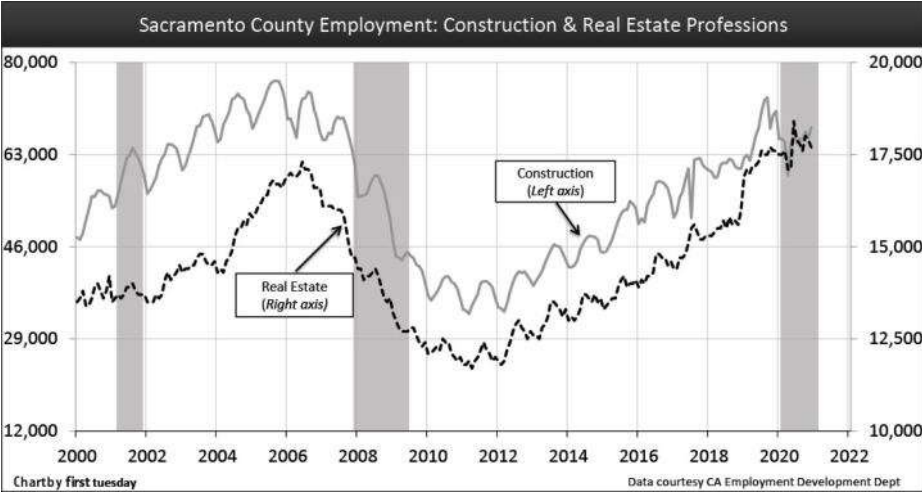
Employment plays catch up

Figure 18
Sacramento County Payroll Employment
and
Sacramento County Employment: Construction & Real Estate Professions

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	Dec 2020	Dec 2019	Annual change
Sacramento County employment	961,200	1,024,800	-6.2%



	Dec 2020	Dec 2019	Annual change
Construction	68,000	71,000	-4.2%
Real Estate	17,700	17,600	+0.6%

employment following 2015’s initial recovery for total employment to match population levels. At the past pace of job additions, this finally occurred in 2019, a decade after the conclusion of the recession.

This recovery was just in time for the triple whammy of financial crash, pandemic and recession that arrived in 2020. As of December 2020, the number of jobs held is just above the 2007 peak (not counting population gains) and 6.2% below a year earlier. This is slightly less than the job loss experienced statewide, which is 8.0% below a year earlier as of December

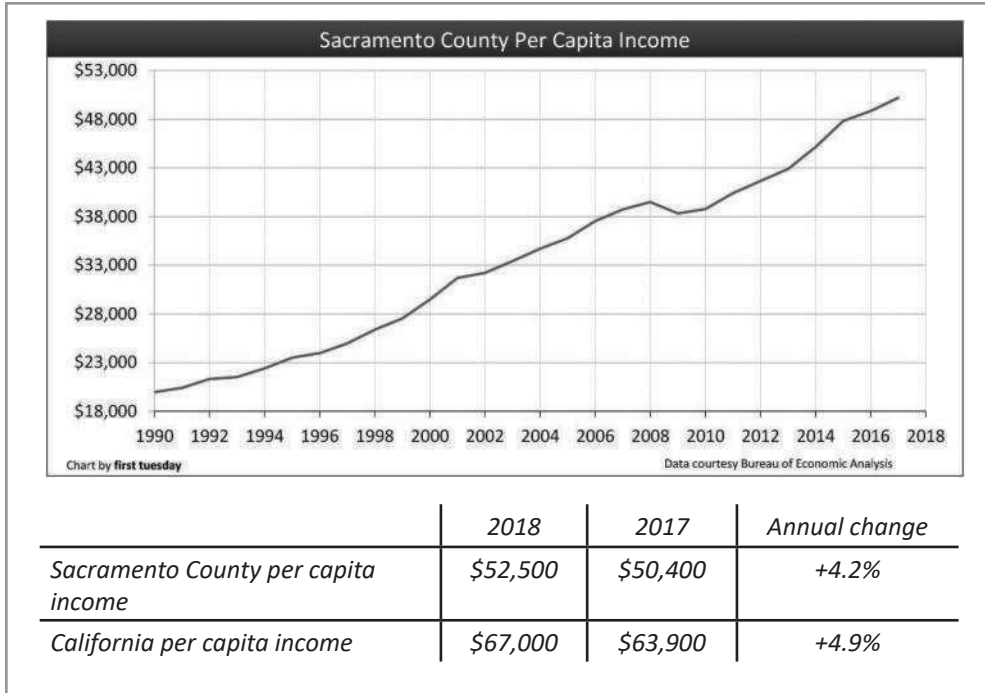


Figure 19
Sacramento County Per Capita Income

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2020. Expect a W-shaped recession in the coming months, with jobs rising and falling, not to begin a true recovery in this inland region until around 2024.

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 100 jobs above the pre-recession peak, construction jobs have much more to regain, at 3,000 below the pre-recession peak.

Some real estate jobs will be cast off in 2021 as transaction volume hesitates, still others will look to supplement their reduced incomes. However, expect construction jobs to be regained more swiftly as more housing is needed to meet demand, currently unsatisfied by historically low inventory. Jobs of all types will begin a more consistent recovery around 2023-2024, filling wallets and in turn fueling **household formations**.

Sacramento County surpassed its 2008 (pre-recession) peak of \$39,700 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.

However, Sacramento County's average income remains below the state average in 2018, 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 on the rise

Annual income increase finally surpassed the pre-recession pace of around 3% a year in 2015. This is about level with the target rate for consumer inflation. Thus, incomes were able to match the ever-increasing price of goods and services beginning in 2017, granting residents an equal 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 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 to see average incomes fall back in 2020-2021, the result of job losses and reduced wages. However, the impact on home prices has been muted due to a rise in buyer purchasing power, the result of historically low interest rates in 2020.

Chapter 25.4 Summary

Sacramento County, encompassing California's capital and cities like Elk Grove, Citrus Heights and Folsom, is home to the California Department of Real Estate (DRE). This region never fully emerged from the elongated economic recovery from the 2008 recession. Home sales volume and construction have stalled, while homeownership recently peaked.

Sacramento was one of the last counties in California to reach an initial pre-recession jobs recovery, necessary to fuel wallets and in turn household formations. Its lagging recovery can be attributed partially to Sacramento's dependence on state and local government jobs, which were slow to return.

However, this recovery was quickly followed by the 2020 recession, resulting in significant job losses and a complete erasure of the past five years of job gains. Looking ahead, as the job losses linger, Sacramento County will see sales volume and prices struggle to maintain momentum. 2020's low interest rates and intense homebuyer competition have thus far propped up home prices. But expect home prices to meet resistance in 2021 with the expiration of the foreclosure moratorium, reaching to recovery mode around 2023-2024. The timing of the coming recovery will largely depend on government intervention, such as job creation or further stimulus.

San Diego County housing indicators

Chapter 25.5

After reading this chapter, you will be able to:

- understand where San Diego County stands on the path of economic expansion following its recovery from the Great Recession of 2008; and
- identify when San Diego County's housing market will experience a complete housing recovery.

Learning Objectives

42,300 home sales closed in San Diego County during 2020, amounting to 2,100 more homes sold than in 2019, an increase of 5%. For perspective, this small increase still leaves San Diego 50% below peak 2003 sales numbers, but it exceeds the statewide average annual increase of less than half a percent.

A transitory population fuels turnover


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 relatively flat-to-down rate. The stagnant sales volume of the past decade can be attributed to a lack of **end users** who have yet to return to the market in significant numbers.

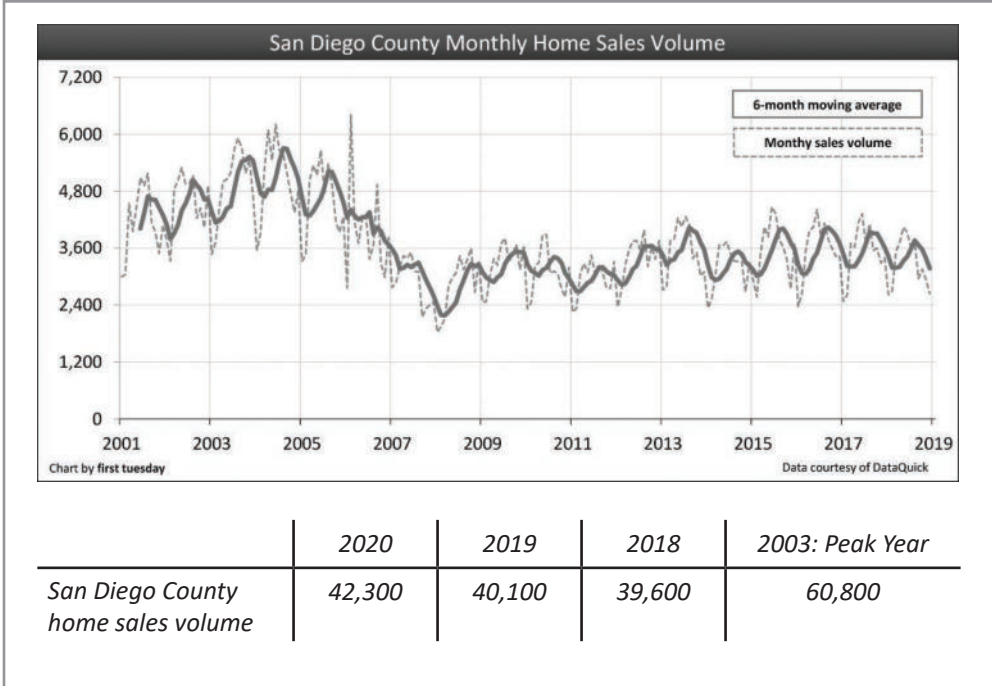
Expect home sales volume to decline in 2021-2022. The job losses stemming from the recession and pandemic have pulled many would-be homebuyers and sellers from the market. Those with mortgages have found themselves delinquent, though thus far have remained in their homes due to the foreclosure moratorium. After the moratorium expires, these homeowners will find themselves heading toward foreclosure, adding to the wave of distressed sales likely to arrive in 2021-2022. Expect sales volume and prices to bottom around 2022, when homebuyers will return in greater numbers to push the housing market to its next recovery, expected to begin around 2023-2024.

The percentage of San Diego County homeowners and renters who moved in 2018 fell back from the previous year. This trend echoes other regions of the state, which saw turnover decline in 2018 following a brief burst in 2017. Turnover rates for both owners and renters still remain well below pre-recession levels.

Turnover rates are up: good for sales

Figure 20
San Diego County Monthly Home Sales Volume


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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.

While the trends are similar to the rest of the state, the magnitude of decline in 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.

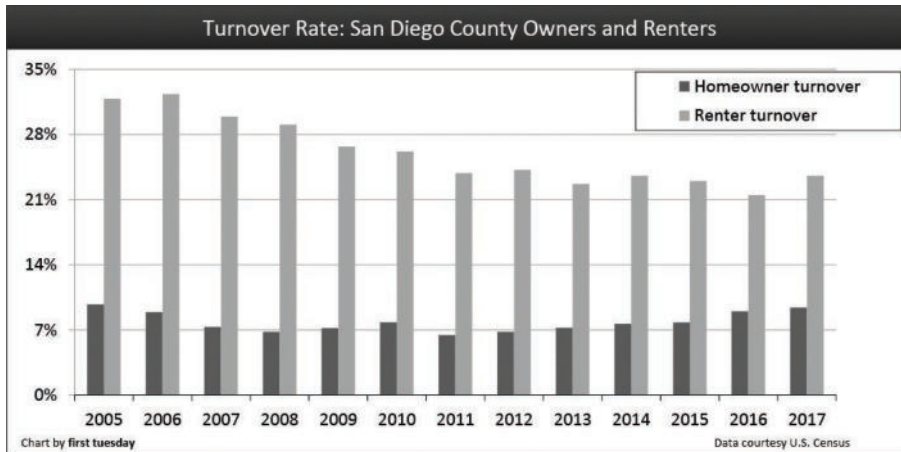
Homeownership rebounds from bottom

San Diego County’s homeownership rate followed the general statewide and national trend of decline in the years following the **Millennium Boom**, bottoming in 2016 at 50.7%. In contrast, homeownership peaked at 63% in 2006 in San Diego County.

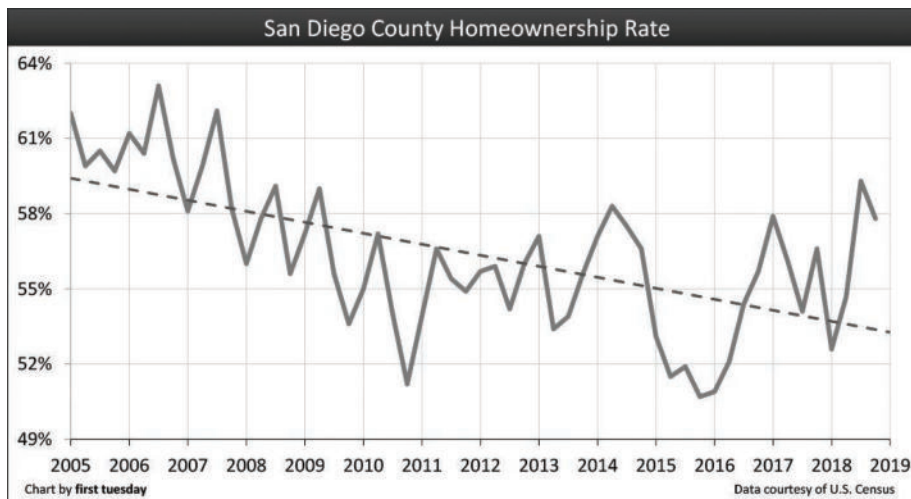
The **homeownership rate** in San Diego County has historically been comparable to the rest of the state, though it is above the statewide average of 56.3% in Q4 2020. When home prices adjust downward going into 2022 due to the expected uptick in distressed sales, the homeownership rate won’t rise significantly until homebuyers regain confidence in the housing market, returning in larger numbers in the years following 2023.

Home prices continue to rise

Home prices continues to skyrocket in San Diego. Lower mortgage rates free up more of a buyer’s monthly mortgage payment to put towards a bigger




	2018	2017	2016
San Diego County homeowner turnover rate	7.6%	9.4%	9.0%
San Diego County renter turnover rate	22.5%	23.6%	21.5%



	Q4 2020	Q3 2020	Q4 2019
San Diego County homeownership rate	56.3%	61.5%	59.4%

Figure 21


Turnover Rate: San Diego County Owners and Renters
and
San Diego County Homeownership Rate

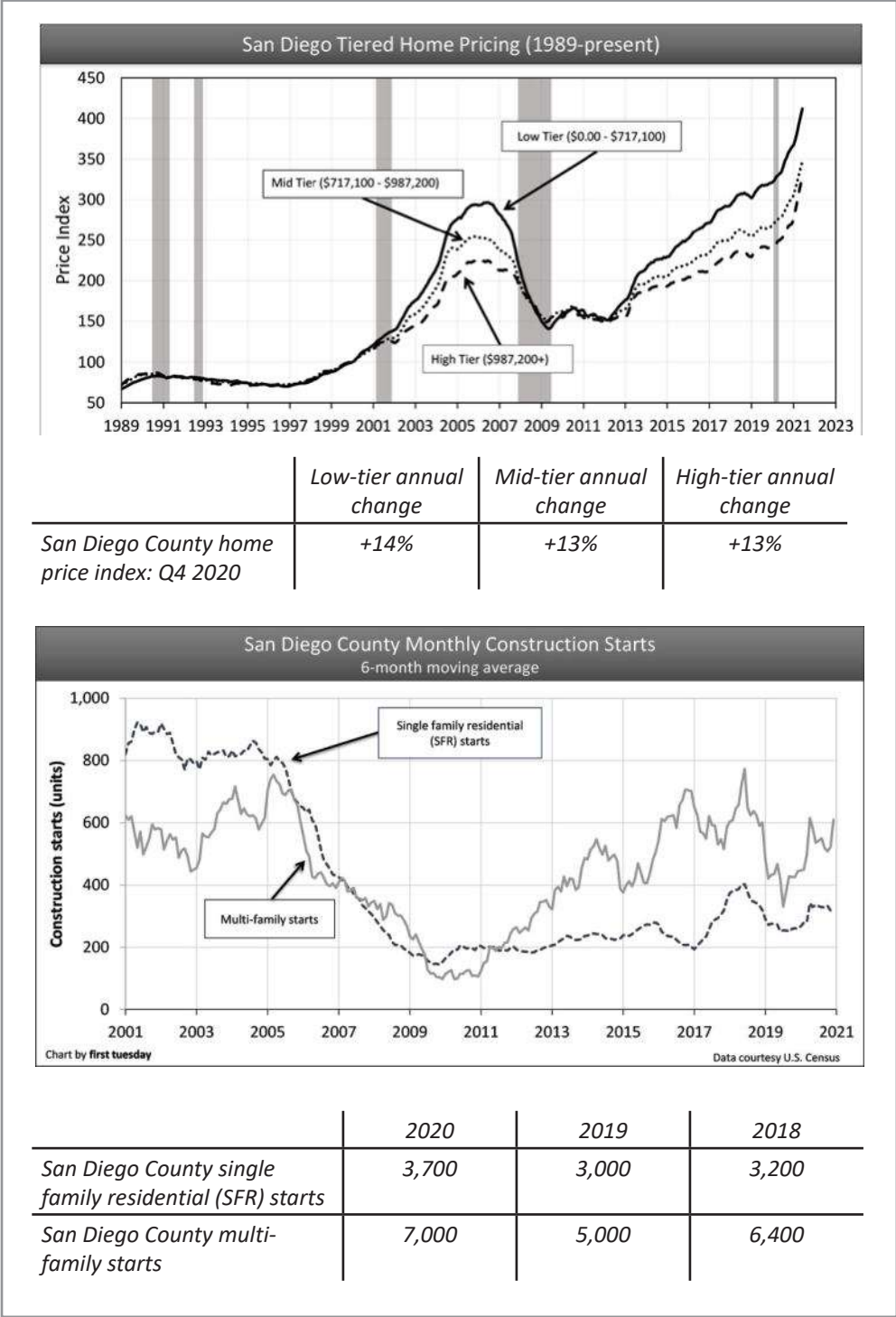

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principal. Thus, San Diego’s high home prices continued to find fuel from the historically low interest rates of 2020, translating to increased **buyer purchasing power**.

In 2021, home prices will begin to feel the impact of record job losses and months of built-up delinquent inventory, headed for foreclosure upon the expiration of the foreclosure moratorium later in 2021. The overall home price trend for the next couple of years will be down, the result of job losses

Figure 22
San Diego Tiered Home Pricing (1989-present)
and
San Diego County Monthly Construction Starts


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and plummeting sales volume. As during the 2008 recession, the drop in sales volume and prices will first be most volatile on the coast, before rippling outward to inland areas.

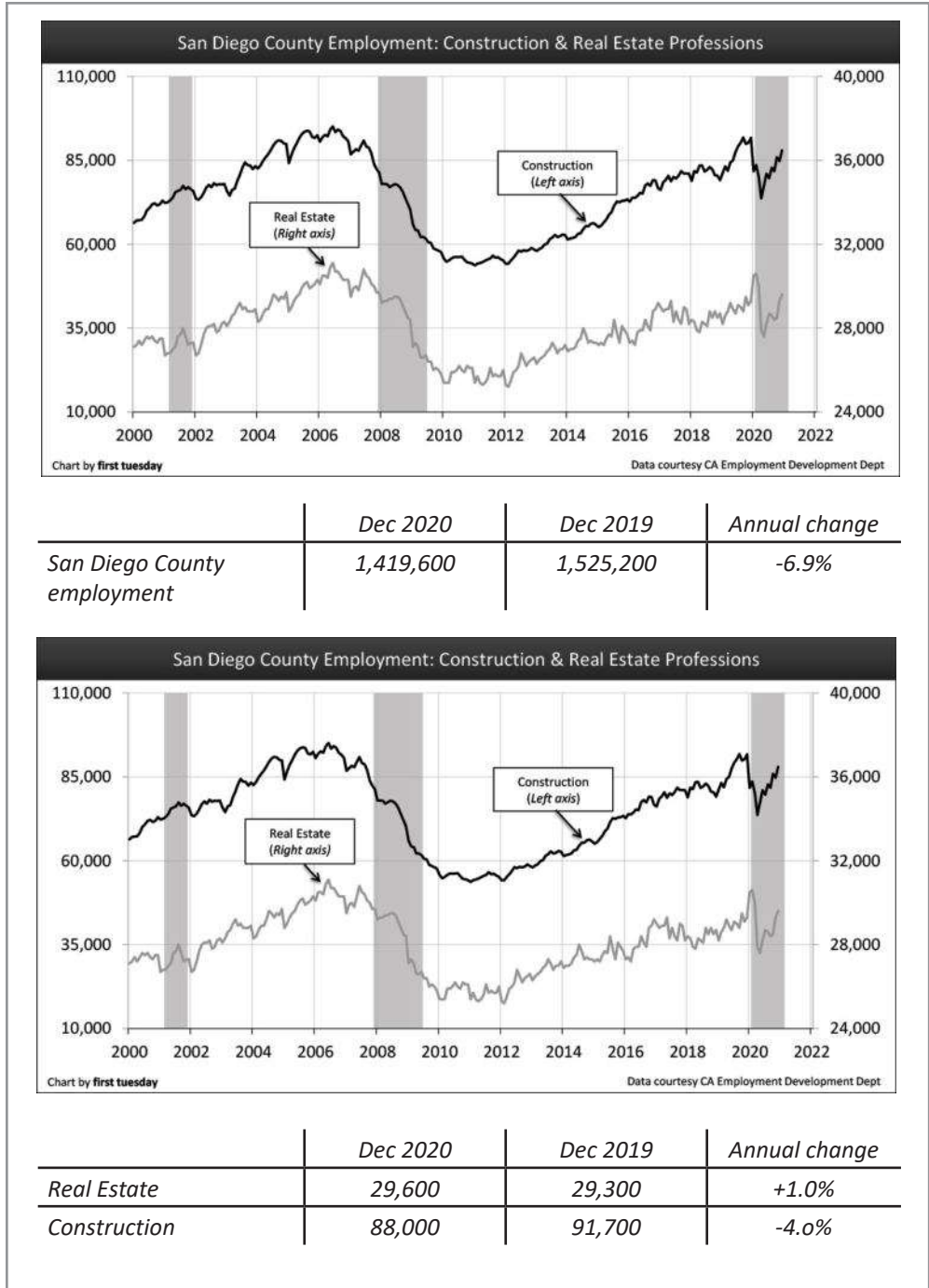


Figure 23
San Diego County Payroll Employment and San Diego County Employment: Construction & Real Estate Professions


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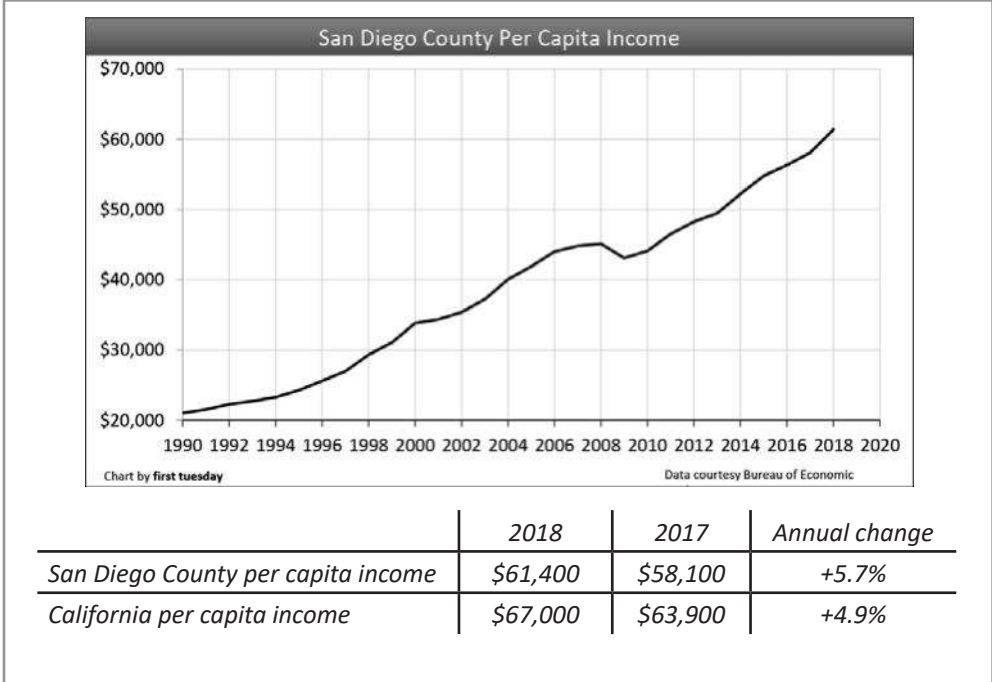
Residential construction starts rebounded in 2020, rising 23% for single family residential (SFR) starts and 40% for multi-family starts. Until 2018, the recovery had been concentrated in **multi-family starts**, due to the increased demand for rental housing experienced during this recovery. Fueling this increased rental demand are:

- a demand shift from suburban living to city dwelling by the youngest generation of homebuyers, Generation Y (Gen Y);

Multi-family construction leads the way

Figure 24
San Diego County Per Capita Income


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- 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 **SFR** construction starts in San Diego County is still far below 2002-2004 numbers. The next peak in SFR construction starts will likely begin around 2023. Even then, SFR construction starts are highly unlikely to return to the frenzied mortgage-driven numbers seen during the Millennium Boom.

Jobs recovery slows in 2019

Before *end users* can provide sufficient support for housing, the workers who lost their jobs in 2020 will need to re-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.

Unlike other parts of the state with less stable employment markets, San Diego surpassed the level of jobs held prior to the 2008 recession well before the 2020 recession set in. However, the job losses experienced statewide, which is 7.6% below a year earlier as of December 2020. This is slightly better than the job loss experienced statewide, which 8% below a year earlier at the end of 2020. Expect a *W-shaped* recession in the coming months, with job gains happening sporadically, not to enter a true recovery until around 2023-2024.

In the housing industry, construction jobs have gradually regained numbers over the past decade of recovery from the 2008 recession, nearing a full recovery. Likewise, the number of employed real estate professionals has

remained low throughout the past recovery, rising slowly. In 2020, both industries experienced a hit to job numbers, though both have bounced back fairly quickly compared to other industries. The real estate profession will not likely experience a sustained increase until the next confluence of buyers and renters (members of the **Generation Y** and **Baby Boomer** generations) converge on the market in the years following 2023.

The average per capita income in San Diego County is \$61,400 as of 2018, the most recently reported Census year. This shows an average increase in income of 5.7% over 2017. Income took a hit in San Diego during the 2008 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 2018 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 roughly 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, employment numbers and income won't drive demand for significant additional new housing until after the recovery from the 2020-2021 recession.

Like much of the state, San Diego County never fully recovered from the 2008 recession and financial crisis before the recession, financial crash and pandemic slammed the region in 2020.

The economic response to COVID-19 and the underlying recession caused record job losses in 2020, which are very gradually being recovered. Still, 2020's record-low interest rates have maximized buyer purchasing power and inflated home prices. As we head deeper into the recession, expect to see home sales volume and prices decline, dragged down by the coming wave of distressed sales upon expiration of the foreclosure moratorium. Government intervention in the form of further stimulus or an extension of the foreclosure moratorium may prop up the housing market in the coming months, but without job creation, these efforts will merely put off the inevitable decline. San Diego's housing market will likely begin a consistent recovery around 2023-2024.

Per capita income has recovered

Chapter 25.5 Summary

Chapter 25.6

San Francisco County housing indicators

Learning Objectives

After reading this chapter, you will be able to:

- understand where San Francisco stands as California heads into a recovery from the 2020-2021 recession; and
- identify when San Francisco experienced a full housing recovery, and the direction home sales are headed in the future.

A step ahead of the rest of the state

Home sales volume in **San Francisco County** is volatile, but has tended to run a step ahead of the rest of the state in terms of trends. San Francisco home sales volume peaked in 2004 — a year before the statewide peak — before receding in 2005-2006. Home sales volume bumped along at a relatively level-to-down annual pace in 2012-2016, but fell significantly in 2017, a signal of the statewide downturn in sales taking place in 2018. But this decrease reversed course in 2018, with year-end totals up 12% from 2017, yet still below 2016 numbers.

San Francisco, with its heavy concentration of high-paying tech jobs and depressingly low housing inventory, is almost an economy unto itself. Decreased economic expectations and still-high home prices in the region have caused homebuyer enthusiasm to wane sharply in 2020. As we head deeper into the 2020 recession, look for home sales to continue to decrease throughout 2021-2022.

Turnover rates are mixed

San Francisco's **renter turnover rate** fell back slightly in 2018 to 18.8%, meaning fewer than one-in-five San Francisco renter households moved in 2018. On the other hand, the **homeowner turnover rate** (producing sales and relocating buyers) rose slightly in 2018, still at just 6.6%. This low turnover rate is reflected in the small increase in sales volume also experienced in 2018.

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.

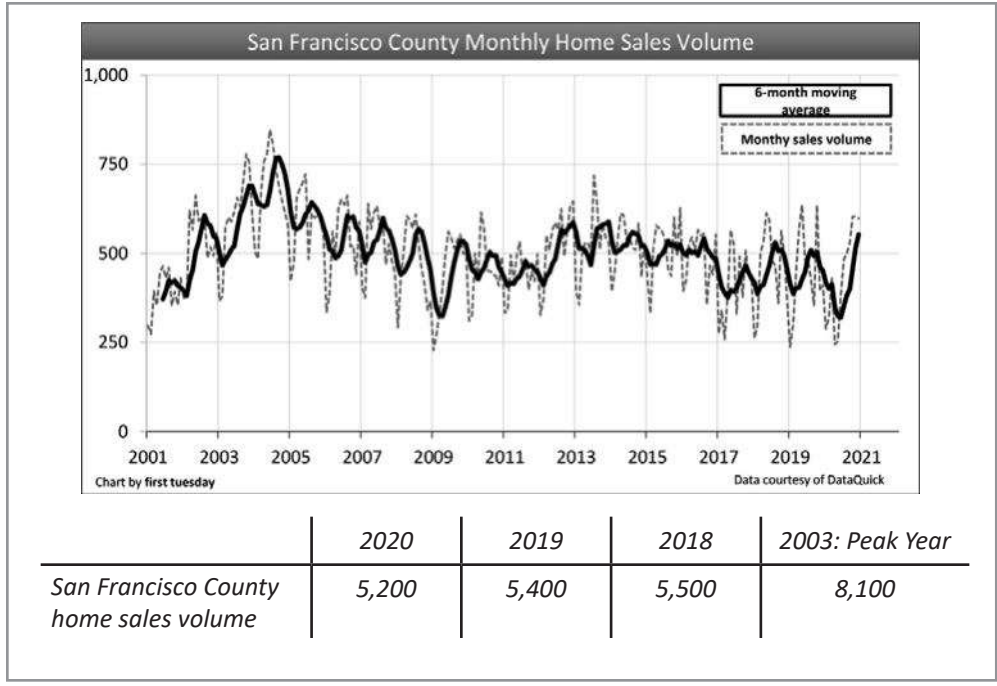


Figure 25
San Francisco County Monthly Home Sales Volume

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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 2022-2023, 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. As of Q4 2020, the homeownership rate is just below 52%, well below the statewide average of 55.6%.


Overall, the homeownership rate in San Francisco has not suffered quite as much as the rest of the state during the protracted recovery due to the job support delivered by its successful tech industry. All the same, due to the high cost of housing and the allure of city living, renting is often preferred in San Francisco.

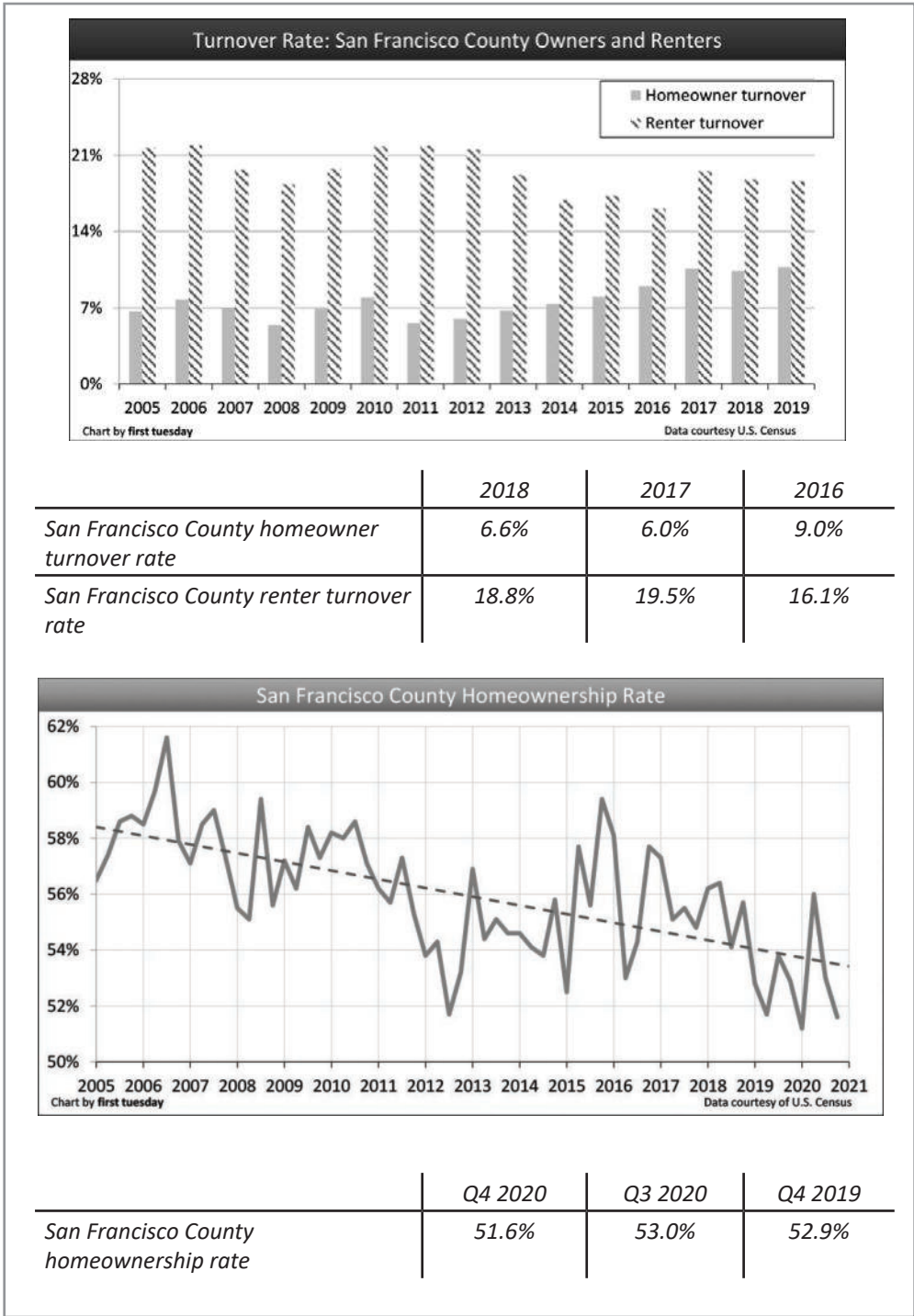
San Francisco home prices are characterized by rapid starts and stops, as viewed in the bumps in the chart above — particularly in the mid- and high-tiers. Pricing in Southern California markets form a smoother line. San

Homeownership to improve gradually

Jumbos and ARMs drive home prices

Figure 26
Turnover Rate:
San Francisco
County Owners
and Renters
and
San Francisco
County
Homeownership
Rate


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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.

As of Q4 2020, low-tier prices are 9% higher than a year earlier, mid-tier prices are 10% higher and high-tier prices are 8% higher. This significant annual price rise is atypical for a recession year but not as dramatic as the statewide average annual price increase.

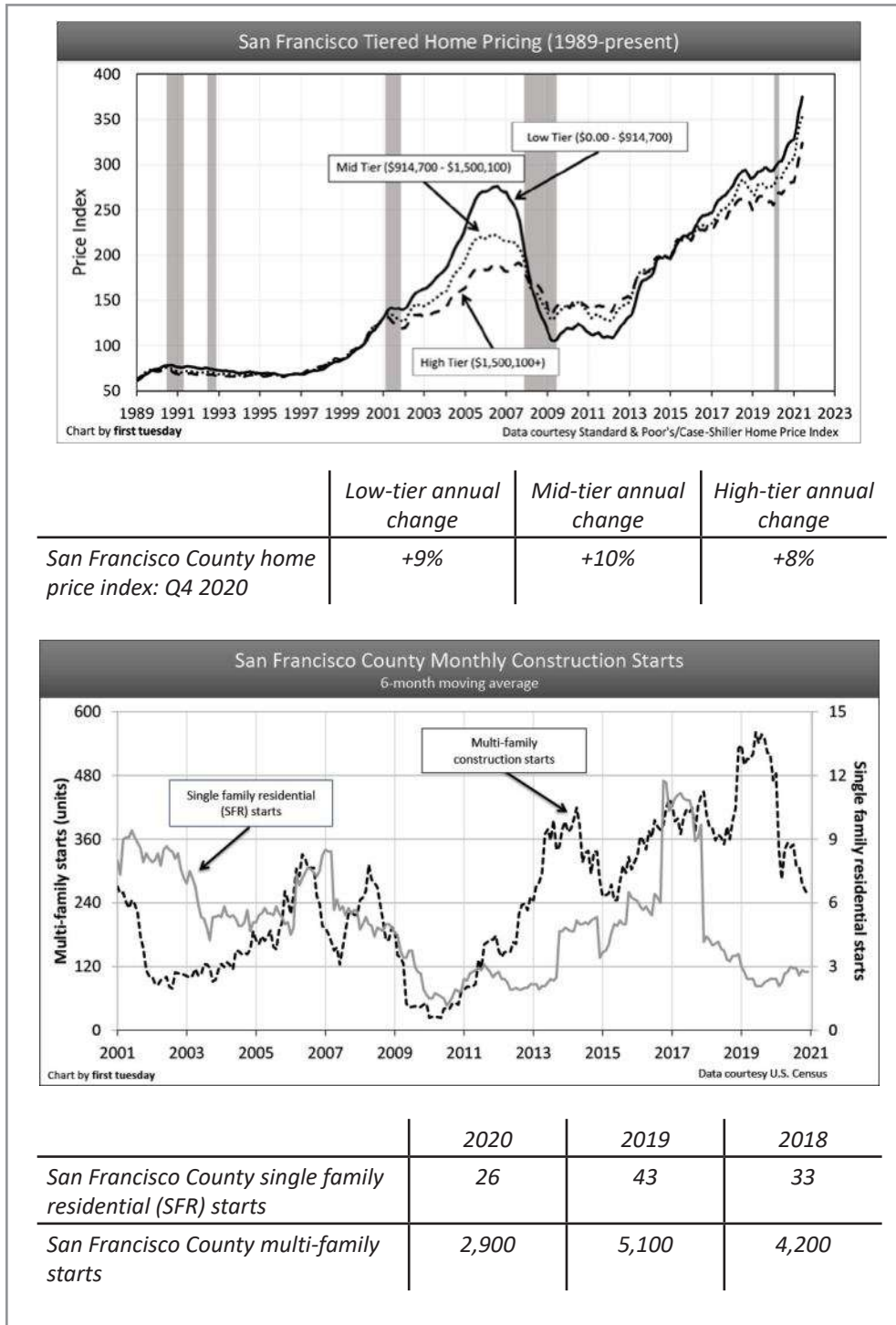




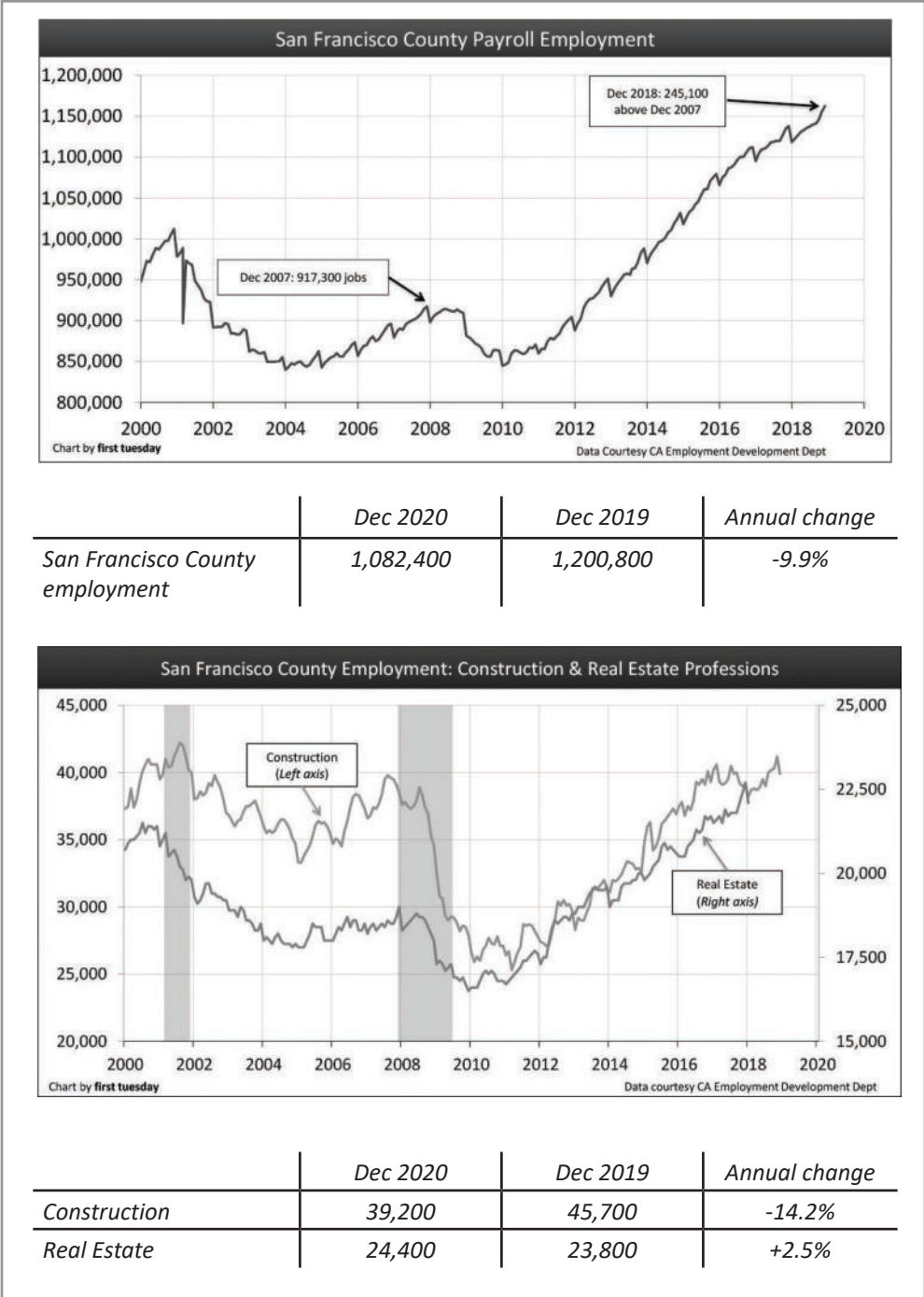
Figure 27
San Francisco Tiered Home Pricing (1989-present)
 and
San Francisco County Monthly Construction Starts


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Accurate home price reports run about two months behind current events. Even when caught up, “sticky prices” tend to persist several months beyond the moment when home sales volume begins to slow. Starting in March 2020, economic volatility and shelter-in-place orders caused home sales volume to decline. However, historically low interest rates have provided a boost for buyer purchasing power, which propped up home prices in 2020.

Figure 28
San Francisco County Payroll Employment
and
San Francisco County Employment: Construction & Real Estate Professions


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In the coming months, continued job losses along with the expiration of the foreclosure moratorium will see downward pressure on home prices. The overall home price trend for the next couple of years will be down, the result of historic job losses and declining sales volume. As during the 2008 recession, the drop in sales volume and prices will first be most volatile on the coast, before rippling outward to inland areas.

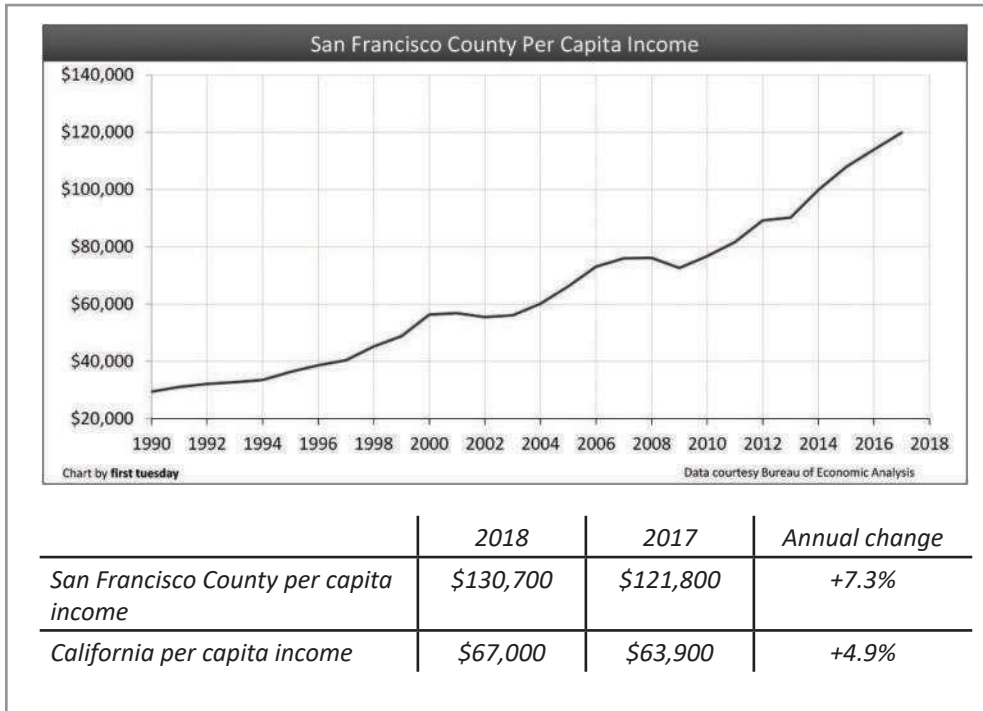


Figure 29
San Francisco County Per Capita Income

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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, have increased swung wildly from year-to-year, though the general trend has been up since their bottom in 2010. The long approval and permitting process in San Francisco holds down construction starts of all types.

As jobs continue to be centered 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.

Unlike most of the state, San Francisco’s jobs market has well surpassed the point for recovery from the 2008 recession when the 2020 recession hit. 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 over the past decade.

Jobs have met and exceeded residents’ need for employment, even including San Francisco’s **population increase** of roughly 70,000 working-age

Multi-family construction gains

Jobs fully recovered — and rising

individuals since the start of the 2008 Great Recession. By a statewide comparison, California just caught up to pre-recession levels in mid-2014, finally meeting the intervening population increase in 2019.

However, what was gained was quickly lost. The economic response to **COVID-19** on top of the underlying recession has caused record job losses across the state, and San Francisco is no exception. San Francisco's job numbers are 9.9% below the prior year as of December 2020. Expect to see these job losses pull down prices in 2021-2022 when the foreclosure moratorium expires and those who are jobless with a mortgage find their bills come due.

The number of people employed by each of San Francisco's top employing industries has increased over the prior year. In particular, *Professional and Business Services*, which includes the technology and support industries, has added the most jobs during this economic recovery.

Employment in the **real estate** industry has well exceeded pre-recession levels. The **construction** industry has suffered greatly during 2020, the result of shelter-in-place orders that have often been more restrictive in the Bay Area compared to the rest of the state. However, the dire need for more residential construction continues. Thus, construction will continue to see growth throughout this decade.

Per capita income has recovered

Per capita income in San Francisco is roughly double that of California's, having increased at a significantly quicker pace than most of California in recent years.

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. Sales are likely to fall back in 2021 due to rising interest rates and too-high home prices. For, even though incomes here are higher than virtually anywhere else in the state, rising incomes still don't keep up with the cost of housing.

San Francisco is a unique region in California's housing landscape. Here, home prices have far surpassed the pre-Millennium Boom years and jobs were recovered quickly following the 2008 recession due to the presence of the high-paying tech industry.

All the same, high prices and limited inventory have shut out many residents, causing a housing crisis for renters and homebuyers alike. Further, the region's enviable jobs recovery does not shield San Francisco residents from the 2020 recession, induced by years of economic build-up, on top of the financial crash earlier this year and the response to the global pandemic.

Expect to see San Francisco's rapid home price increases reverse direction later in 2021 due to the continuing recession and expiring foreclosure moratorium. Further, the remote work trend has caused an increasing number of San Francisco residents to flee the metro area for less expensive, nearby suburbs, reducing homebuyer competition in the city. The housing market will begin to recover from the 2020 recession here in San Francisco and across the state around 2023-2024, the timing of which will largely depend of the existence of further government stimulus, job creation and/or moratorium extensions.

Chapter 25.6 Summary

Chapter 25.7

Santa Clara County housing indicators

Learning Objectives

After reading this chapter, you will be able to:

- understand where Santa Clara County stands in its current housing cycle; and
- identify the future direction of home sales and prices in Santa Clara County's housing market.

The tech industry feeds price increases

Santa Clara County home sales volume has been stagnant since 2012, hovering below 20,000 each year, with 16,700 homes closing during 2020. Despite a downward spiral in the first half of the year, 2020 annual sales volume ended up rising 2% above 2019 as many homebuyers delayed purchasing during the pandemic. Still, this small 2% increase isn't saying much when, after 2019, it remains the second-lowest level of home sales volume experienced in Santa Clara in the past decade.

Prior to the decrease in 2018 and 2019, Santa Clara home sales volume was essentially stagnant since 2012. The reason for Santa Clara's long-term flat-to-down home sales volume? Home prices in the Santa Clara/San Jose area are inflated well beyond income raises, 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.

In 2021, the economic fall-out from the global pandemic along with the underlying recession continue to weigh down the state's housing market. Expect to see sales volume remain low in 2021 as the region grapples with job losses and and low homebuyer confidence.

Turnover is flat

It's no surprise Santa Clara County's housing turnover rate is stagnant, given the county's resulting flat home sales volume. With high rents and home prices, more people stay put. In 2018, one-in-four renters moved in Santa Clara, decreasing further in 2018.

Santa Clara's quick pace of population growth will help churn Santa Clara County's turnover rate in the post-recession years, first as increased renter turnover followed by a rise in homeowner turnover – once residential construction catches up to the demand. 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.

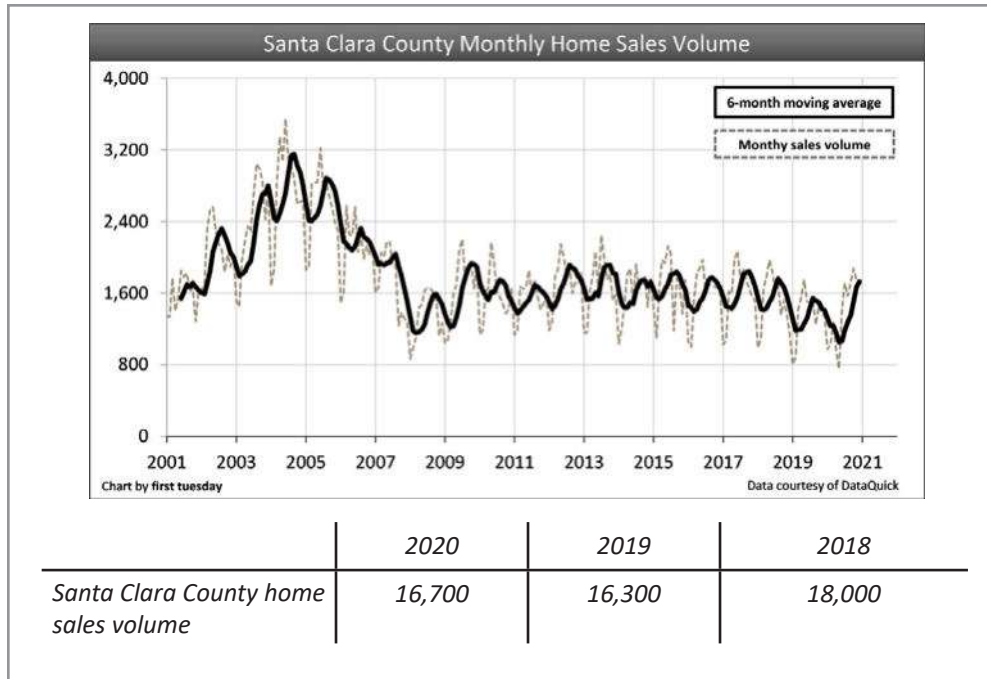


Figure 30
Santa Clara County Monthly Home Sales Volume

ONLINE UPDATE
 Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.

While varying greatly from quarter to quarter, Santa Clara County’s long-term homeownership rate trended downward from 2005 through 2015, when homeownership bottomed at a very low 45%. Since then, the region’s rate of homeownership has climbed slightly, just below 54% in Q4 2020.

The rest of the state has experienced a swift decline in homeownership since the 2008 recession, peaking at over 60% in 2006, at 55.6% in Q4 2020. 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, to be tested in the next couple of years as the state continues to claw its way out of the hangover from the 2020 recession.

After years of steady recovery, construction experienced some setbacks in 2020 in Santa Clara County. **Single family residential (SFR)** starts remained flat for the third year in a row, while **multi-family** decreased 9%.

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 large suburban SFR. And while multi-family construction has improved gradually since the Millennium Boom years, it’s still insufficient to keep up with demand from the region’s ever-growing population.

SFR and multi-family starts will likely hit their peak following Generation Y’s delayed entrance into the housing market in 2023-2024. This will be helped along by new legislation intended to combat the growing housing shortage by fostering more construction.

Homeownership feels the pressure of high home prices

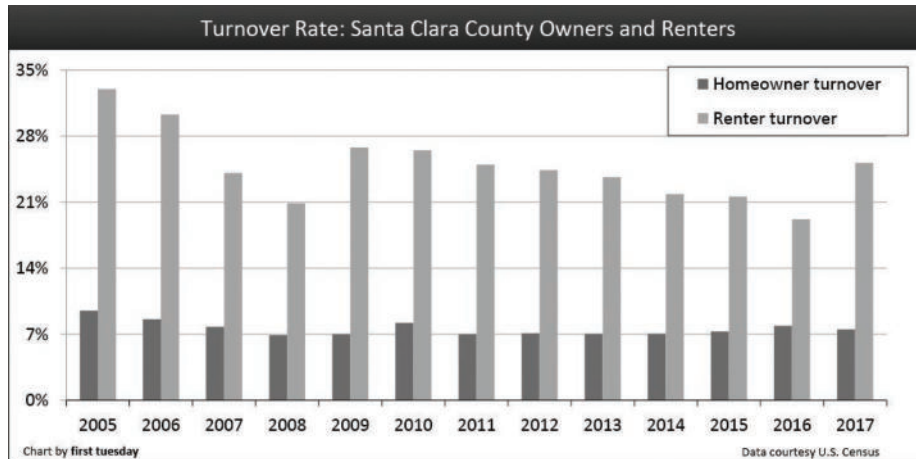
Construction boom trails off

Figure 31

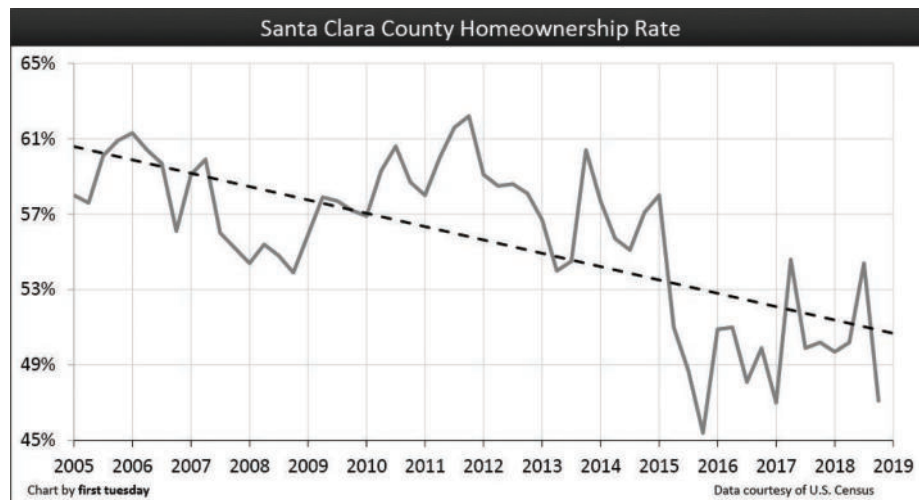
**Turnover Rate:
Santa Clara
County Owners
and Renters
and
Santa Clara
County
Homeownership
Rate**



ONLINE UPDATE
Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.



	2018	2017	2016
<i>Santa Clara County homeowner turnover rate</i>	6.3%	7.5%	7.9%
<i>Santa Clara County renter turnover rate</i>	23.4%	25.2%	20.4%



	Q4 2020	Q3 2020	Q4 2019
<i>Santa Clara County homeownership rate</i>	53.7%	54.6%	51.9%

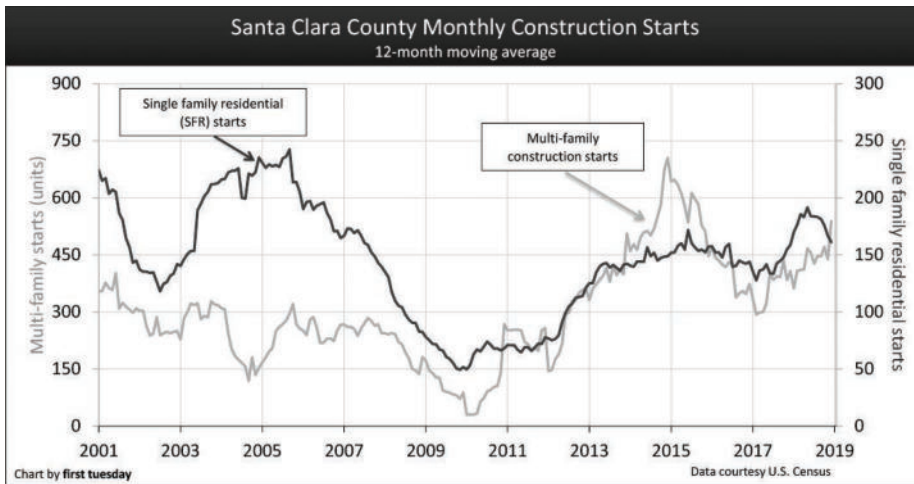
**Employment
growing strong**

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 didn't reach a post-population-gain recovery until 2019.




	Dec 2020	Dec 2019	Annual change
<i>Santa Clara County employment</i>	1,082,500	1,166,100	-7.2%



	2020	2019	2018
<i>Santa Clara County single family residential (SFR) starts</i>	1,900	1,900	1,900
<i>Santa Clara County multi-family starts</i>	4,200	4,600	6,500

Figure 32
Santa Clara County Payroll Employment and Santa Clara County Monthly Construction Starts


ONLINE UPDATE
 Visit [realtypublications.com/charts](https://www.realtypublications.com/charts) for the most recent chart data.

Why did Santa Clara’s job market recover more quickly than the rest of the state, and will it do the same following the 2020-2021 recession? Roughly one-quarter of the jobs added since the recovery from the 2008 recession 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.

Figure 33

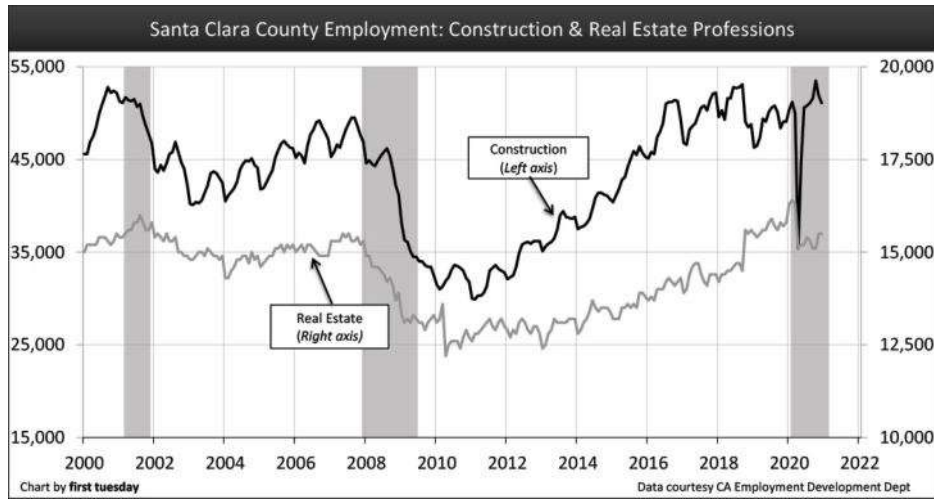
Santa Clara County Employment: Construction & Real Estate Professions

and

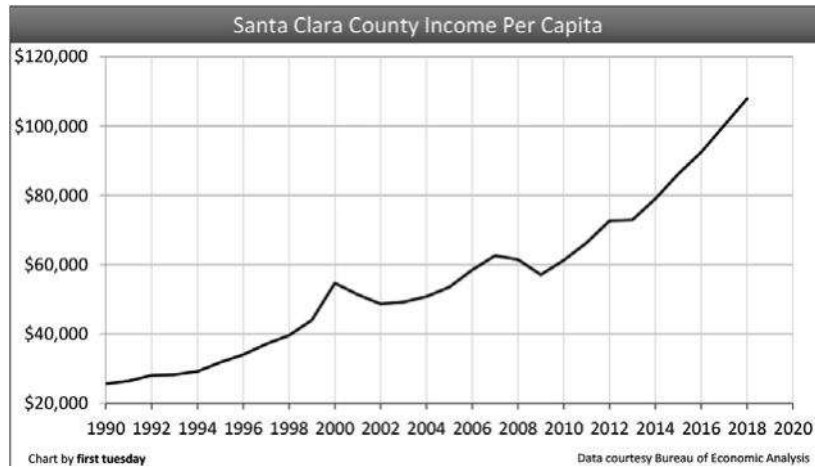
Santa Clara County Income Per Capita



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



	Dec 2020	Dec 2019	Annual change
Construction	51,100	49,100	+4.1%
Real Estate	15,500	15,800	-1.9%



	2018	2017	Annual change
Santa Clara County per capita income	\$107,900	\$100,200	+7.7%
California per capita income	\$67,000	\$63,900	+4.9%

However, what was gained can be lost. The economic response to COVID-19 has caused record job losses across the state, and the San Jose metro area is no exception. As of December 2020, Santa Clara County has lost 83,600 jobs from its December 2019 peak. Expect to see these job losses impacting real estate in 2021 and the years ahead.

Santa Clara County personal incomes are well above the statewide average. Further, from 2017 to 2018 incomes increased a significant 7.7% in the region, the largest gains in the state.

But these income increases are not all that they seem. The high cost of housing in Santa Clara has pushed out many low- and moderate-income residents. So, while average incomes have increased in the region, the rapid pace of increase is at least partly due to many residents being forced to move to less costly areas.

Despite these relatively large income boosts, incomes actually need to increase much faster to meet the area's rate of home price rise if home prices and rents are to be maintained. Home prices will need to fall in line with homebuyer incomes, especially since **rising mortgage interest rates** have reduced buyer purchasing power in 2018. Interest rates have since fallen back, but global economic uncertainty and still-high home prices have caused homebuyers to hesitate. Therefore, expect home prices to continue down in 2022 as we make our way out of the 2020-2021 economic recession.

Income rising quickly

Santa Clara County was well on its way to a full housing recovery going into 2020. Residential construction was booming and buyer incomes were rising at a much quicker pace than the rest of the state. However, annual home sales volume has remained level-to-down since 2012, decreasing each year since 2018.

The past decade of Santa Clara's successes has been due to its strong 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 sales volume.

In 2020, the economic response to the global pandemic alongside the underlying recession caused job losses to ripple across the state. In 2021, Santa Clara County will see sales volume continue to falter, bottoming around 2023. The forthcoming expiration of the foreclosure moratorium means distressed sales are on the horizon, which will cause home prices to cool. Thus far into the recession, historically low interest rates have counteracted slowing sales to prop up home prices. But as interest rates inch higher and buyer purchasing power declines, the price bump won't last. Once the foreclosure moratorium is lifted, expect distressed sales on top of the region's job losses and reduced incomes to drag down prices. Look to the recovery, around 2023-2024, for the next consistent bump to sales and prices.

Chapter 25.7 Summary

Notes:

Glossary

#

- 1-year Treasury Bill** 41
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** 12
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** 46
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** 111
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**..... 46
The rate used by sellers to impute and report interest when a seller is not paid interest on their §1031 monies.

A

- absorption rate** 242
The estimated time required to sell or lease property within a designated area at its fair market value.
- adjustable rate mortgage (ARM)** 9, 109, 258
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** 259
The government's push to increase the homeownership rate from the historical 64% to 70%.
- applicable federal rate (AFR)**..... 44
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** 189
An opinion estimating a property's value on a specific date resulting from an analysis of facts about the property.
- appraisal waiver** 353
The option for a homeowner or homebuyer to have their property appraised based on automated information to generate an appraised home value, rather than with a walkthrough viewing of the physical property.
- appreciable asset** 53
A collectible, such as real estate. The value of this asset may increase with time beyond the rate of consumer inflation.
- asset price inflation** 131
A rise in the price of assets, such as stocks, bonds and real estate.
- availability** 359
Property marketed for sale or lease.

B

- Baby Boomers** 201, 206, 226
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** 74
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** 268
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)** 64
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.
- bracket creep** 309
When taxpayers move up into a higher tax bracket despite no real increase in income, resulting in higher tax payments.
- building envelope** 365
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** 80
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** 26
The ideal moment to buy property, characterized by low prices, low interest rates and few willing buyers.
- buyer purchasing power** 32
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** 237
Long-term income property investment.

C

- capitalization rate (cap rate)** 8, 86, 208
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** 232
Attached, freestanding, or over-the-garage apartments that have no direct access to the main house.
- commodity** 131
A marketable good or service.
- community banks** 279
Small and local banks not tied to the "too big to fail" Wall Street banks.
- competitive advantage** 260
Increasingly drastic lending measures motivated by the desire for ever greater earnings and strategic advantage over one's rivals.
- construction starts** 156
Building permits issued before builders may begin construction.
- consumer confidence** 301
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)	121
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)	126
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	126
An increase in the general price level of all goods and services consumed in the economy.	
Continental	264
An early form of currency issued by Congress after the start of the Revolutionary War.	
Cost of Funds Index	43
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	248
The reduction of the principal balance of a mortgage debt to the value of the mortgaged real estate.	
creditworthiness	4
An individual's ability to borrow money, determined by their present income and previous debt payment history.	
D	
dead cat bounce	37
An initial brief rebound in home prices following a crash in property pricing; not indicative of the beginning of a true recovery.	
debt overhang	181
Excess mortgage debt on a negative equity property.	
debt-to-income ratio (DTI)	35
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	40
The interest rate the Federal Reserve charges banks and thrifts who borrow funds directly from the Fed to maintain reserve requirements.	
disequilibrium	129
An extreme imbalance in supply and demand which prevents the market from reaching equilibrium in pricing.	
dis-saving	206, 227
The act of cashing in savings and liquidating assets to spend on goods and services.	
diversification	238
Varying the types and areas of investment in a portfolio to mitigate risk.	
Dodd-Frank Wall Street Reform and Consumer Protection Act	121
A federal consumer protection law which created minimum standards and oversight for consumer mortgage origination.	
E	
easy money	268
When there is too much cash in circulation causing excessive inflation, rectified by the Federal Reserve increasing short-term interest rates.	
emigration	318
The act of leaving a country or state for another.	

end user 25
 A buyer who will occupy the property as their residence or own it as income property for long-term investment purposes.

energy audit 364
 An inspection which pinpoints a home’s energy-efficient improvements and features in need of energy-efficient improvements.

energy efficiency 364
 Using building materials, appliances or other methods to reduce the amount of energy used by the homebuyer, thereby reducing their energy costs.

entrepreneurial spirit 323
 Individuals exhibiting creativity and ingenuity. Willing to adopt new, innovative techniques to succeed.

exchange rate 289
 The fluctuating rate at which one currency is converted to another, such as for the purpose of purchasing in a foreign market.

F

fair market value (FMV)..... 111, 189
 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 280
 A government-sponsored entity operating in the secondary mortgage market.

federal funds 41
 Overnight funds lent to banks with insufficient reserves by the Federal Reserve and other banks with excess reserves.

Federal Housing Administration (FHA)-insured mortgage 248
 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) 267
 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 258
 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 267
 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 266
 The 12 branches of the “central” bank.

fiat money..... 126
 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 134
 The cyclical phenomenon of increasingly larger loan amounts based on increasingly inflated prices of the same collateral.

first-time homebuyer 345
 A buyer of a home who has not previously owned their shelter. Typically aged 25-34.

- flipping** 61
Buying and quickly reselling a property to obtain a large profit, the basis of speculation.
- forbearance agreement** 70
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** 265
1837-1862. No central banking system existed during this time. States chartered their own banks and held their own reserves.
- fully indexed rate** 10
The highest rate possible on the adjustable rate mortgage (ARM) during the first five years of its term.
- G**
- Generation Z (Gen Z)** 92
The up-and-coming generation of first-time homebuyers, consisting of individuals born in the late-1990s and the 2000s.
- Generation Y (Gen Y)** 92, 203
The forthcoming generation of first-time homebuyers, consisting of individuals born in the 1980s and 1990s.
- going negative** 135
The Federal Reserve's charging of interest on the excess reserves of lenders, stimulating lending activity.
- Great Confluence** 233
The convergence of retiring Baby Boomers and Generation Y on the same urban real estate.
- Greenspan Put** 14
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)** 148, 288
The market value of all goods and services produced within a country calculated over a set period of time.
- gross revenue multiplier (GRM)** 86, 97
Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.
- H**
- hit-and-run buyers** 186
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** 365
A rating system established by the Department of Energy quantifying the energy performance of a home.
- home equity line of credit (HELOC)** 66
A mortgage loan enabling a homeowner to borrow against their home's wealth, as an ATM.
- homeowner vacancy rate** 170
The percentage of unoccupied homeowner housing units.

household formation244
 Individuals who acquire their own property, such as adult children leaving parents' households or singles leaving shared housing.

I

illiquid asset 74
 An asset that cannot be converted into cash quickly without a loss.

implicit rent66, 87
 The value of an owner's use of their property to house themselves or their business.

income approach 86
 The use of a property's rental income to set its value.

income inequality 148
 The uneven distribution of wealth across the population.

Individual Taxpayer Identification Number (ITIN) 318
 A nine digit, tax processing number issued by the Internal Revenue Service to individuals who don't have a social security number.

infill.....359
 The development of vacant land located within existing urban areas to add value by making improvements.

inflation 8
 The price changes over time in consumer goods and services, quantified in the consumer price index.

installment sale 108
 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 30
 Properties available on the market for sale through the multiple listing service.

invested capital 8
 The total amount of cash and mortgage principal an owner has used to acquire and improve a property.

J

John Maynard Keynes274
 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.

L

labor force participation (LFP) rate 344
 The share of the population that is either employed or unemployed but actively seeking employment.

leveraging 108
 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..... 74
 A financial debt or obligation owed to others.

limited liability company (LLC) 211
 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** 136
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)** 67
A ratio stating the outstanding mortgage balance as a percentage of the mortgaged property's fair market value.
- long-term rate** 8
An interest rate fixed for the duration of the mortgage.

M

- mean price trendline** 193, 255
A reflection of consumer inflation, to which property prices cyclically return.
- median age** 335
The midway point between the older half of a population and the younger half.
- momentum traders** 185
Buyers relying on the emotion of frenzied market participants, rather than property price inflation, to profit from buying and reselling property.
- monetarist economic view** 122
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** 18
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)** 118
An asset-backed security representing a claim on the cash flows received on a mortgage.
- mortgage interest deduction (MID)** 308
An itemized deduction which allows mortgaged homeowners to deduct their mortgage interest paid in a tax year from their incomes when calculating income tax payments.

N

- negative equity** 69
The condition of a property owner owing more on a mortgage than the current fair market value of the encumbered property.
- net absorption** 360
The percentage change in occupied space over a period of time, which can be positive or negative.
- net income multiplier (NIM)** 86, 206
The property's price as a multiple of the net operating income.
- net operating income (NOI)** 15
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)** 169
The notice recorded to begin the nonjudicial foreclosure process.

O

- operating costs** 372
The total annual cost projected to maintain and operate a property for one year. [See **RPI** Form 306]

opportunity cost 66, 236
 The cost of an action that is forgone in choosing to take an alternative action.

P

per capita income 332
 A measure of average income per person in a population center.

price appreciation..... 87
 Any increase beyond the rate of consumer inflation above the price paid for property experienced by the owner on its resale.

price tier 176
 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 206
 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 rate 43
 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 303
 A tax exclusion on profit from a home sale up to a set dollar amount.

property appreciation..... 222
 The portion of the increase in property prices beyond the rate of inflation.

put option 9
 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) 139
 A consumer mortgage which meets ability-to-repay rules under the Truth in Lending Act.

qualified residential mortgage (QRM) 121, 140
 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) 129
 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) 210
 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) 81
 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 18
 The desired fixed rate of return on the investment in excess of the future rate of inflation.

- rental vacancy rate** 171
The percentage of unoccupied rental housing units.
- renters by necessity** 339
Households for whom traditional ownership of their shelter is not economically possible.
- rentier** 272
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)** 108
A measure of earnings in relation to capital invested.
- risk tolerance** 235
The amount of investment risk an investor is willing to accept.
- S**
- savings rate** 162
The percentage of an individual's monthly disposable income which is not spent.
- securitization** 113
The process of Wall Street bankers breaking up mortgage pools into mortgage-backed bonds and selling these bonds to various banks and individual investor.
- sell phase** 26
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.
- senior** 231
Those over the age of 65.
- shadow inventory** 55, 356
The inventory of properties whose pending release onto the market (e.g., REOs, foreclosures, speculator holdings) will destabilize real estate sales volume and prices.
- shareowners** 212
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.
- short-term rate** 8
A variable interest rate which changes often, driven by Federal Reserve actions to keep inflation and deflation in check.
- skin in the game** 143
A risk management measure of a purchaser's stake in an investment, such as a homebuyer's down payment on a home purchase.
- speculator** 110
A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.
- standard deduction** 308
The income tax deduction which taxpayers who do not itemize their deductions may subtract from their incomes when calculating income tax payments.
- statement of financial position** 74
A balance sheet prepared by a homeowner which lists the dollar amounts of the homeowner's assets and liabilities. [See **RPI** Form 209-3]
- sticky pricing** 38, 180
A seller's irrational reliance on past home pricing as a basis for setting current pricing, called the money illusion.
- subsidy** 261, 300
The government support of a particular entity or activity. For homebuyers, these come in the form of tax credits.

syndication 58, 237
 When a group of investors form a limited liability company to fund the purchase price and carrying costs of owning real estate.

T

teaser rate 36, 114
 A temporary, low introductory interest rate found in some adjustable rate mortgages.

tenants-by-foreclosure 163
 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.

tranches 113, 269
 Bonds issued by investment pools divided into various levels of risk, reward and rate of maturity.

Treasury Bills (T-Bills) 269
 Government securitized debt instruments. T-bills are sold to the public, member banks and other financial institutions.

turnover rate 408
 The percentage of households relocating each year, whether from rentals or ownership.

U

undocumented immigrant..... 318
 An individual who enters a country without the approval of that country.

universal homeownership..... 320
 The idea that everyone can and should be able to own a home. Similar to the American Dream policy.

V

vicious economic cycle 261
 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.

virtual showing..... 349
 A video-based tour of the property, provided in real-time with an agent or pre-recorded as part of their listing services.

Y

yield spread 17, 28
 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)..... 243
 The household financial situation where a mortgage debt commitment when coupled with other necessities exceeds disposable income.

zero lower bound interest rates 135
 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 160
 Building and land use restrictions enacted by local policy makers to ensure a consistent flow of improvements to meet the demand of population growth.

Quizzes

Instructions: Quizzes are open book. All answers are multiple choice. Quizzes are **optional** and may be taken as many times as you like. Answer key is located on page 445.

QUIZ 1

Chapters 1.1–2.4

1. Of all the economic factors, _____ has the most impact on the vigor of the California real estate market.
 - a. weather
 - b. employment
 - c. war
2. The basis for an individual's _____ is a paycheck, self-employed earnings from a trade or business, or income from investments.
 - a. return on investment (ROI)
 - b. real demand
 - c. creditworthiness
3. The percentage of the California population who owned their homes peaked in 2006 around:
 - a. 50%.
 - b. 61%.
 - c. 85%.
4. The loss of jobs affects _____ real estate.
 - a. only single family residential (SFR)
 - b. only commercial
 - c. all types of
5. The two basic categories of interest rates are:
 - a. long-term and short-term.
 - b. state and federal.
 - c. high and low.
6. The U.S. economy functions on a _____ interest rates cycle.
 - a. 10-year
 - b. 15-year
 - c. 60-year
7. The yield spread is the difference between the 10-year Treasury note rate and the:
 - a. 6-month Treasury bill rate.
 - b. 3-month Treasury bill rate.
 - c. London Inter-Bank Offered Rate (LIBOR).
8. The desired fixed rate of return on the investment in excess of the future rate of inflation is known as the:
 - a. return of investment.
 - b. real rate of return.
 - c. yield spread premium.

9. The Buy Phase, the ideal moment for buying property, is characterized by cyclically low prices and:
 - a. low interest rates.
 - b. few willing buyers.
 - c. Both a. and b.
10. When the economy gives mixed signals, prudent real estate investors enter a:
 - a. buy phase.
 - b. hold phase.
 - c. sell phase.

QUIZ 2

Chapters 2.5-4.2

1. Lenders will allow no more than _____ of a homebuyer's monthly gross income to be used on a monthly mortgage payment.
 - a. 100%
 - b. 31%
 - c. 95%
2. _____ are overnight funds lent to banks with insufficient reserves by the Federal Reserve (the Fed) and banks with excess reserves.
 - a. Cost-of-Funds Index
 - b. Discount rates
 - c. Federal funds
3. A(n) _____ is a transaction in which sales proceeds are reinvested by acquiring like-kind property and the profits on the sale are deferred until the investment is cashed out.
 - a. equity purchase
 - b. discount transaction
 - c. §1031 transaction
4. A(n) _____ refers to a collectible, such as real estate, the value of which may increase with time beyond the rate of consumer inflation.
 - a. basket of goods
 - b. appreciable asset
 - c. mutual fund
5. A speculator's delegation of a purchase agreement's obligations to a substitute buyer is known as a(n):
 - a. assumption.
 - b. right of rescission.
 - c. waste.
6. When purchasing a residential property from a seller-in-foreclosure, a speculator is subject to _____ laws, which protect vulnerable sellers.
 - a. lemon
 - b. anti-flipping
 - c. equity purchase (EP)

7. 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 is referred to as a(n):
 - a. equity purchaser.
 - b. bona fide purchaser (BFP).
 - c. carryback seller.
8. _____ is the lost interest which would have been earned by investing income instead of allocating it to building home equity.
 - a. Gross operating income
 - b. Net income multiplier (NIM)
 - c. Opportunity cost
9. _____ is the condition which occurs when the market value of real estate is less than the mortgage which encumbers it.
 - a. Free-and-clear ownership
 - b. Negative equity
 - c. Absorption
10. A _____ temporarily reduces a homeowner's mortgage payment, but it does not permanently alter the mortgage terms.
 - a. forbearance agreement
 - b. verbal agreement
 - c. cramdown

QUIZ 3

Chapters 4.3–6.3

1. Compared to the rest of the nation, the rise and fall in home prices experienced in California during the years leading up to the Great Recession was:
 - a. mild.
 - b. severe.
 - c. average.
2. Going into 2019, just over _____ of California's homeowners were underwater on their homes.
 - a. 12%
 - b. 2%
 - c. 8%
3. A _____ is a worksheet used to list in dollar amounts all a homeowner's assets and liabilities.
 - a. statement of financial position
 - b. bankruptcy declaration
 - c. listing agreement
4. An asset that cannot be converted easily into cash without taking a loss is called a(n):
 - a. illiquid asset.
 - b. liquid asset
 - c. solid asset
5. The dollar amount an owner receives by occupying the space themselves is called:
 - a. implicit rent.
 - b. actual rent.
 - c. the net income multiplier (NIM).

6. Renters-by-necessity are _____ to purchase a home.
 - a. financially unable
 - b. unwilling
 - c. Neither a nor b.
7. State-initiated legislative efforts to address California's housing shortage have focused on adding more:
 - a. multi-family properties.
 - b. single family residences (SFRs).
 - c. farms.
8. The gross revenue multiplier (GRM) is calculated by dividing the:
 - a. annual rent a comparable property commands by its operating expenses.
 - b. cost of the property amenities by the value of the raw land.
 - c. sale price of a residence by the annual rent it or a comparable property commands.
9. Investment in property aesthetics and the appearance of family stability are types of _____ favorably associated with owning a home.
 - a. financial amenities
 - b. social amenities
 - c. cultural amenities
10. During the coming decade a buyer will generally need to stay in the property for a minimum of _____ years to break even.
 - a. one or two
 - b. four or five
 - c. six or seven

QUIZ 4

Chapters 7.1-7.3

1. A real estate mortgage appears as a _____ on title to a property allowing the lender to enforce the mortgage by nonjudicial foreclosure.
 - a. temporary easement
 - b. trust deed lien
 - c. property tax assessment
2. The alternative to a real estate loan as a source of additional capital is:
 - a. speculator activity.
 - b. seller financing.
 - c. purchase-assist financing.
3. The _____ associated with adjustable rate mortgages (ARMs) is unacceptable except for the most wealthy and sophisticated investors.
 - a. teaser rate
 - b. risk of loss
 - c. short-term rate
4. The price a reasonable, unpressured buyer and seller agree to pay for property on the open market is known as the property's:
 - a. fair market value (FMV).
 - b. asking price.
 - c. appraised value.

5. Appraisers are regulated through intermediary:
 - a. banks.
 - b. real estate brokers.
 - c. appraisal management companies (AMCs).
6. Unless a homebuyer wants to pay for private mortgage insurance or take out a Federal Housing Administration (FHA)-insured loan, they will need a down payment equal to:
 - a. 20%.
 - b. 10%.
 - c. 3.5%.
7. The capital adequacy ratio addresses a bank's level of:
 - a. liquidity.
 - b. solvency.
 - c. payday loans.
8. Pools of mortgage-backed bonds (MBBs) are sold to banking institutions and investors in a process called:
 - a. reverse amortization.
 - b. assumption.
 - c. securitization.
9. The temporary, low initial interest rate found in adjustable rate mortgages (ARMs) is called a:
 - a. teaser rate.
 - b. sticky rate.
 - c. short-term rate.
10. Deregulation in the lending industry between 1982 and 2007 permitted and encouraged:
 - a. reckless lending.
 - b. responsible lending.
 - c. less lending.

QUIZ 5

Chapters 8.1–9.2

1. _____ is an increase in the general price level of all goods and services in the economy.
 - a. Consumer price inflation
 - b. Asset price inflation
 - c. Both a. and b.
2. The Federal Reserve (the Fed) controls inflation by controlling the amount of money:
 - a. in circulation.
 - b. held by bankers.
 - c. held in personal savings accounts.
3. An extreme imbalance in supply and demand is referred to as:
 - a. disequilibrium.
 - b. quantitative easing (QE).
 - c. asset price inflation.

4. A(n) _____ is able to be used again and again over a long term and is subject to deterioration and obsolescence.
 - a. product
 - b. commodity
 - c. asset
5. The phenomenon of increasingly larger mortgage amounts due to increasingly inflated prices of the same collateral is called the:
 - a. American Dream effect.
 - b. financial decelerator effect.
 - c. financial accelerator effect.
6. The Federal Reserve's (the Fed's) practice of charging interest on the excess reserves of lenders to stimulate lending activity is known as:
 - a. going sideways.
 - b. going positive.
 - c. going negative.
7. The liquidity trap is a condition occurring when injections of cash into the banking system _____ lending and economic growth.
 - a. fail to stimulate
 - b. help to increase
 - c. directly cause
8. "QRM" in the mortgage industry stands for:
 - a. qualified residential mortgage.
 - b. quantified reverse mortgage.
 - c. quick reciprocal monies.
9. When consumer confidence is running high, the rate of personal savings:
 - a. rises.
 - b. falls.
 - c. stays the same.
10. California's gross domestic product (GDP) is growing _____ than personal incomes.
 - a. at the same rate
 - b. slower
 - c. faster

QUIZ 6

Chapters 10.2-12.4

1. Construction will first begin to blossom in the communities of _____ where high-tech information and service jobs are increasingly centered.
 - a. central California
 - b. the Inland Empire
 - c. coastal California
2. Homeowner vacancies represent the number of:
 - a. occupied single family residences (SFRs).
 - b. unoccupied rental housing units.
 - c. unoccupied homeowner housing units.

3. In California, recording a _____ is the first step in the foreclosure process.
 - a. notice of delinquency (NODq)
 - b. notice of default (NOD)
 - c. notice of nonresponsibility (NON)
4. When the Millennium Boom began in 2002, rental vacancies:
 - a. began to fall as more people began leasing rental properties.
 - b. were static and did not significantly vary from prior years.
 - c. began to rise as tenants jumped on the homebuying bandwagon.
5. The most detailed way to understand home price changes is to view these changes through a:
 - a. tiered-home pricing lens.
 - b. median pricing lens.
 - c. average pricing lens.
6. The best way to initially evaluate a property and set its price is to study:
 - a. comparable property values in the same demographic location.
 - b. the median national property values.
 - c. comparable property values in a neighboring city.
7. _____ refers to the tendency of listed prices in owner-occupied real estate to resist change.
 - a. Comparable pricing
 - b. Price persistence
 - c. Median price
8. The excess mortgage debt on a negative equity property is referred to as:
 - a. debt overhang.
 - b. replacement cost.
 - c. loan-to-value (LTV) ratio.
9. The task of property evaluation to qualify a property as collateral for the repayment of a loan is completed by a(n):
 - a. broker.
 - b. appraiser.
 - c. agent.
10. Roughly _____ of a property's value comes from its improvements. The remaining _____ comes from the land it is situated on.
 - a. 25%; 75%
 - b. 75%; 25%
 - c. 50%; 50%

QUIZ 7

Chapters 12.5–15.2

1. Other than during price bubbles, home prices have historically trended with the rate of:
 - a. consumer inflation.
 - b. Treasury bills (T-bills).
 - c. adjustable rate mortgages (ARMs).

2. The _____ is a simple abstraction used to compare the price of a stock with the earnings of the company.
 - a. price-to-earnings (P/E) ratio
 - b. gross income multiplier (GIM)
 - c. momentum market multiplier (MMM)
3. Stock market investors look to _____ when they want to invest in income-property ownership without the liabilities of ownership or property management.
 - a. passive rental income
 - b. real estate investment trusts (REITs)
 - c. price-to-earnings (P/E) ratios
4. Investors in real estate investment trusts (REITs) and other securities are referred to as:
 - a. shareowners.
 - b. bona-fide purchasers.
 - c. speculators.
5. When speculators overvalue stocks, a _____ tends to occur.
 - a. home price bubble
 - b. recession
 - c. stock bubble
6. Due to the savings lost in the Great Recession and financial crisis, many Baby Boomers anticipate:
 - a. no retirement.
 - b. an early retirement.
 - c. a delayed retirement.
7. Upon retirement, the vast majority of retirees who owned a home will:
 - a. continue to pursue some form of traditional ownership.
 - b. rent a unit in a multi-unit dwelling.
 - c. cohabituate with their children.
8. As individuals approach retirement, their risk tolerance typically:
 - a. increases.
 - b. decreases.
 - c. stays the same.
9. Adult children leaving parents' households or singles leaving shared housing for their own property is an example of:
 - a. financial atrophy.
 - b. de-leveraging.
 - c. household formation.
10. Compared to the Baby Boomers (Boomers), Generation Y (Gen Y):
 - a. finds high-skilled labor and purchases real estate earlier.
 - b. is taking longer to accumulate the wealth needed to purchase a home.
 - c. marries and settles down earlier.

QUIZ 8**Chapters 15.3–18.2**

1. In the pursuit of higher-education, Generation Y (Gen Y) is raking up unprecedented amounts of _____, which is incompatible with mortgage financing standards.
 - a. job experience
 - b. income
 - c. student debt
2. Generation Y (Gen Y) will likely settle in _____ ripe with professional opportunity and close to areas of cultural significance.
 - a. rural areas
 - b. suburban
 - c. urban areas
3. Buyer purchasing power consists primarily of mortgage interest rates and:
 - a. annual income.
 - b. personal savings.
 - c. Both a and b.
4. With the availability of easy money during the Millennium Boom, bankers had the impetus to provide mortgage funds to:
 - a. the same volume of borrowers as prior years.
 - b. as few borrowers as possible.
 - c. as many borrowers as possible.
5. When growth slows after an economic boom, this is referred to as a:
 - a. virtuous cycle.
 - b. vicious cycle.
 - c. circular cycle.
6. The Federal Reserve's (the Fed's) mandate is to keep our economy stable by _____ and maintaining both job and price stability.
 - a. creating legislation to regulate the secondary mortgage market
 - b. directly setting consumer interest rates charged by private banks
 - c. maintaining sufficient dollars in circulation
7. The rate on the money private banks pay to the Federal Reserve (the Fed) is called the:
 - a. discount rate.
 - b. Glass-Owen Act.
 - c. rate of inflation.
8. To ensure the central bank would not cater to a particular political interest, the Federal Reserve (the Fed) was established as _____ District Reserve Banks.
 - a. 6
 - b. 24
 - c. 12
9. The _____ refers to those who lend money or let real estate.
 - a. rentier class
 - b. debtor class
 - c. austerity class

10. As part of the New Deal after the Great Depression, the government created the _____ to facilitate economic stimulus.
- Federal Housing Administration (FHA)
 - central bank
 - Both a. and b.

QUIZ 9

Chapters 19.1–22.2

- One of the reasons why U.S. property can be such a good investment for an international homebuyer is due to fluctuating:
 - weather.
 - exchange rates.
 - attitudes towards immigration.
- Under the principal residence profit exclusion, taxpayers who sell their principal residence may exclude up to _____ of profit per taxpayer from being taxed.
 - \$150,000
 - \$200,000
 - \$250,000
- To be eligible for the mortgage interest deduction (MID), homebuyers are required to finance their purchase with:
 - a mortgage.
 - cash.
 - an adjustable rate mortgage (ARM).
- As part of the 2018 federal tax changes, the standard deduction roughly:
 - stayed the same.
 - decreased by half.
 - doubled.
- _____ occurs when taxpayers are shifted into higher income tax brackets, despite no real increase in income after accounting for inflation.
 - Bracket creep
 - Environmental creep
 - Itemized creep
- Efforts to increase residential density are often thwarted by vocal _____ advocates.
 - suburban
 - construction
 - not-in-my-backyard (NIMBY)
- Demographic information released by the _____ can be used to anticipate future population-driven real estate sales and leasing trends.
 - U.S. Department of Agriculture
 - U.S. Census Bureau
 - U.S. Military

8. _____ measures the average income per person in a population center and sets the average amount of money spent by members of the community.
 - a. Per capita income
 - b. Net worth
 - c. Minimum wage rates
9. One type of _____ occurs when retirees remove their wealth from the stock market.
 - a. "dis-buying"
 - b. "dis-spending"
 - c. "dis-savings"
10. More highly-educated populations tend to seek out higher-paying employment, which are mostly available in:
 - a. higher-density population centers.
 - b. lower-density rural areas.
 - c. higher elevations

QUIZ 10

Chapters 23.1–25.7

1. When individuals drop out of the labor force, the labor force participation (LFP) rate:
 - a. rises.
 - b. stays the same.
 - c. falls.
2. At the outset of the pandemic, _____ jumped significantly.
 - a. in-person showings
 - b. virtual showings
 - c. cash offers
3. Instead of requiring appraisers to conduct a physical walkthrough to produce an appraised value of property, lenders commonly allowed _____ during the pandemic.
 - a. appraisal waivers
 - b. virtual appraisals
 - c. appraisal skips
4. During the _____, mortgage servicers were prohibited from starting or progressing through the foreclosure process.
 - a. eviction moratorium
 - b. job moratorium
 - c. foreclosure moratorium
5. A(n) _____ audit pinpoints existing energy-efficient improvements, and lists the home's features in need of energy-efficient improvements.
 - a. home inspection
 - b. Energy Star Compliance (ESC)
 - c. Home Energy Rating System (HERS)
6. Turnover rates are highest when _____ are abundant and employee confidence in the economy is high.
 - a. foreclosures
 - b. jobs
 - c. bidding wars

7. The _____ rules limit mortgage funding to homebuyers with the financial ability to actually repay their debts.
 - a. ability-to-repay
 - b. qualified buyer
 - c. ability-to-do-math
8. Riverside County is an example of a(n) _____ for urban centers like Los Angeles and San Diego.
 - a. coastal community
 - b. vacation spot
 - c. bedroom community
9. Home sales volume in _____ County is a step ahead of the rest of the state.
 - a. San Bernardino
 - b. San Francisco
 - c. Sacramento
10. Unlike most of California, _____ reached a full jobs recovery, including regional population growth, in the first quarter (Q1) of 2015.
 - a. Santa Clara County
 - b. Los Angeles County
 - c. Sacramento County

Quiz Answer Key

Real Estate Economics: Realty Almanac 2022-2024

Quizzes are **optional** and may be taken as many times as you like.

Please use the **quiz answer key** provided below to check your answers if you wish to study further for your exams.

The following are the answers to the quizzes for Real Estate Economics and the page numbers where they are located.

Quiz Answer Keys

Page numbers correspond with page numbers in the respective printed book.

Quiz 1 Ch. 1.1-2.4		
1	B	1
2	C	4
3	B	4
4	C	5
5	A	7
6	C	12
7	B	17
8	B	18
9	C	26
10	B	28

Quiz 2 Ch. 2.5-4.2		
1	B	35
2	C	41
3	C	46
4	B	53
5	A	60
6	C	64
7	B	64
8	C	66
9	B	69
10	A	70

Quiz 3 Ch. 4.3-6.3		
1	B	73
2	B	73
3	A	74
4	B	74
5	A	86
6	A	94
7	A	95
8	C	97
9	B	100
10	C	104

Quiz 4 Ch. 7.1-7.3		
1	B	108
2	B	108
3	B	109
4	A	111
5	C	111
6	A	112
7	B	113
8	C	113
9	A	114
10	A	115

Quiz 5 Ch. 7.1-9.2		
1	A	126
2	A	128
3	A	129
4	C	131
5	C	134
6	C	135
7	A	136
8	A	139
9	B	141
10	C	148

Quiz 6 Ch. 10.2-12.4		
1	C	164
2	C	167
3	B	169
4	C	170
5	A	176
6	A	179
7	B	180
8	A	181
9	B	189
10	B	198

Quiz 7 Ch. 12.5-15.2		
1	A	203
2	A	206
3	B	210
4	A	212
5	C	219
6	C	229
7	A	230
8	B	235
9	C	244
10	B	247

Quiz 8 Ch. 15.3-18.2		
1	C	248
2	C	250
3	C	253
4	C	258
5	B	261
6	C	264
7	A	266
8	C	266
9	A	272
10	A	280

Quiz 9 Ch. 19.1-22.2		
1	B	289
2	C	303
3	A	304
4	C	308
5	A	309
6	C	326
7	B	330
8	A	332
9	C	337
10	A	339

Quiz 10 Ch. 23.1-25.7		
1	C	344
2	B	349
3	A	353
4	C	355
5	C	364
6	B	378
7	A	387
8	C	398
9	B	414
10	A	424