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San Diego's Housing Price Meltdown Pulls Economy into Recession

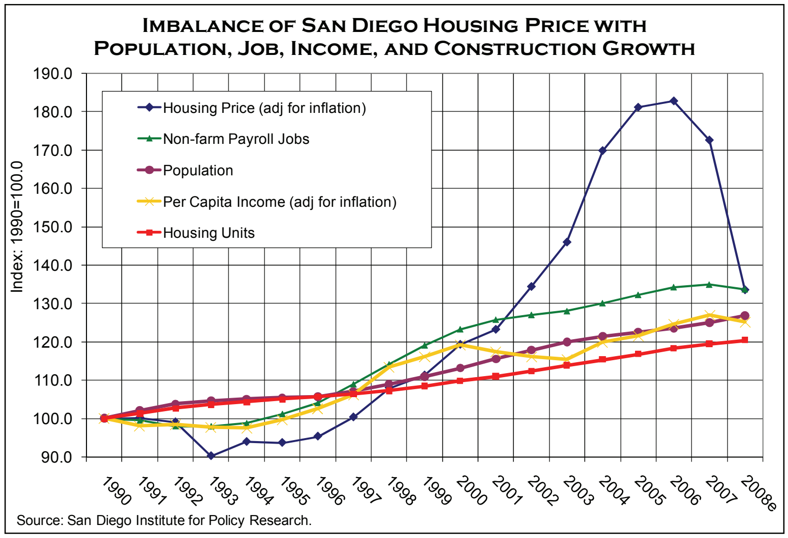
Chairman's Corner

Steven Francis, Founder & Chairman of the San Diego Institute for Policy Research

Fallout from the bursting of the housing bubble has had a dramatic impact on San Diego – far greater than most economists had predicted. Traditionally, housing prices have fallen and risen as a result of underlying economic conditions. For example, the decline in the region's defense economy during the late 1940s and late 1980s ushered in periods of decline prices and rising foreclosures.

The recent downturn has set the world literally on its head. As prices have deflated from unsustainable highs, foreclosures have risen, unemployment in areas related to real estate spiked and consumer confidence has plummeted.

In this issue of the San Diego Economic Ledger, the *San Diego Institute for Policy Research*'s Economist and Senior Fellow, Kelly Cunningham, examines income, housing prices, consumer expenditure patterns and shows why the boom of housing prices was unsustainable and why the "work out" could be lengthy and difficult. As he concludes, with consumers assuming too much debt, the problems in the housing mortgage industry are going to remain in force until a better balance between income and expenditures by consumers are achieved.



The steep declines of San Diego's home prices have not been a major surprise to local economy observers. Housing prices rose too high and too quickly and this was obvious for anyone following the region's consumer dynamics and the housing market. The surprise has been the causes behind and the way in which the fallout has pulled the regional economy into recession, costing thousands of jobs and threatening to undermine economic prosperity for a prolonged period of time. Excessive housing price gains and over-spending by consumers led to imbalances with area incomes and expenditures by San Diego consumers. The fall out now is a necessary market correction from an era of easy money and over-leveraged buying.

Under normal conditions, the housing market is a trailing indicator for other economic activity in the region. When jobs and income rise, demand for homes increase and housing prices follow suit. The construction industry responds by building more housing units, which reaches a point to satisfy the demand for homes. Since it takes a period of time for housing to be built and alleviate the greater demand, prices rise higher. Construction activity may overshoot the market demand, creating an excess of inventory and causing prices to fall. Home price increases are also usually kept in check by affordability levels corresponding to area household incomes. When industry sectors weaken and business activity falters, job losses occur decreasing demand and causing home prices to also falter.

This time these situations did not occur in San Diego. The housing bubble was not created by significant job or income growth. Instead, as is clear now, the spike was fueled by too easily granted mortgages, speculative activity, and "irrational exuberance". Prices increased far beyond income levels that could sustain or justify those prices.

Factors contributing to the rise of home prices may initially have been due to rising employment and incomes, but historically low interest rates following the deflating of the dot.com bubble and post 9-11 terrorist attacks designed to stimulate the economy, played a more significant role in the frenzied home buying market. Lax lend-

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Inside This Issue

Regular readers of the Ledger will note that our tone and outlook have decidedly grown more pessimistic. Whereas SDI had been reasonably upbeat during much of 2007, we believe that 2009 and 2010 will be difficult times for the region's economy.

We can take some small comfort in the fact that we were not alone in being optimistic. For example, in 2007 the UCLA Anderson Forecast said "the problems in real estate will stay in real estate and not affect the rest of the economy".[1]

Unfortunately, this has turned out to not be the case, as the real estate market dragged the overall economy into recession, first in San Diego, then in California, and now the rest of the country. The fallout from slumping real estate prices and, most importantly, the mortgage/financial industry meltdown has led us and most others to make a significant reassessment.

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Housing/Income/Expenditures

(Continued from page 1)

ing standards and "exotic" loan packages further stimulated excessive price gains, while "stated income" loans not verified by the loan grantor, interest only, and variable rate loans allowed many mortgage loans to be granted that previously would have never qualified.

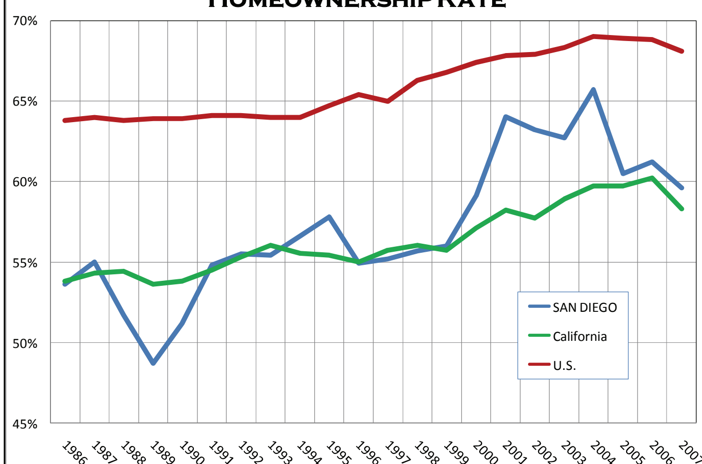
Once prices excessively soared, homes listed for sale started staying on the market longer and prices soon started to slump. Variable and interest-only mortgages began to adjust to higher payment requirements. The result was that more and more homebuyers were unable to afford the resetting payments and started defaulting on their loans. Notices of default rose and banks began foreclosing on properties. This soon led to further price drops and the inventory of homes for sale, unsold and foreclosed upon rose, leading to further price declines.

The subsequent bursting bubble has led to a collapse of consumer finances, confidence, and business activity that undermined the rest of the economy. The housing meltdown created a financial crisis impacting not only San Diego, but now the state and nation. More than any other state, California led out in subprime lending, no-money-down buying, and now, the booming foreclosure market. Of the 25 metropolitan areas with the largest home-price declines in the past 12 months, 16 are in California including San Diego, according to Zillow.com, a real-estate research Web site. San Diego has been at the forefront of all these problems.

Relatively low homeownership in San Diego

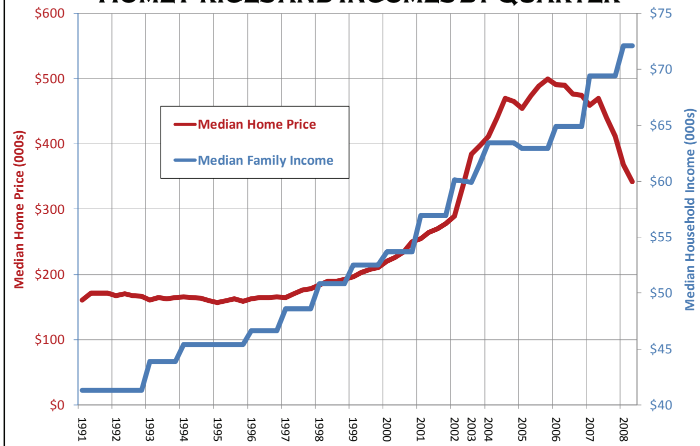
It is important that the recent calamity not completely stifle regional conversations about homeownership and long term economic competitiveness. Homeownership in San Diego and California has historically been lower than in the rest of the U.S. This is partly due to a higher percentage of Californians being new arrivals than residents of other states and being somewhat more transient. However, even controlling for this, variable homeownership rates lag as a result of California's high cost of housing. That puts San Diego companies at a competitive disadvantage as they seek to recruit and retain workers and, as noted below, reduces the amount of discretionary income available to San Diego residents.

Homeownership Rate



Source: U.S. Census Bureau, Housing and Household Economic Statistics Division.

Comparison of San Diego Home Prices and Incomes by Quarter



Source: National Association of Home Builders; San Diego Institute for Policy Research.

When housing prices previously spiked, such as in the late '80 run-up, homeownership worsened. In contrast, during the recent spike, homeownership in San Diego actually increased, reaching a high of 65.7 percent in 2004. This is the closest the local rate has been to the national rate (69.9 percent in 2004) for homeownership in modern history. With the subsequent fallout of the housing market and foreclosures rising, however, San Diego's homeownership rate slumped backward and by 2007 was at a pre-bubble level of 59.6 percent.

Income to home price ratio

One of the most striking aspects of the housing bubble was the temporary delinkage of housing prices to household income. From the 1st quarter of 1995 to the high point reached in the 4th quarter of 2005, home prices more than tripled in San Diego increasing by 218 percent, according to *National Association of Home Builders* (NAHB) data. Over the same period, household income rose only 38 percent.

Since the 2005 peak, San Diego home prices have fallen 32 percent. This occurred despite median household income continuing to rise another 15 percent.

Another way to consider this is to examine the ratio of median housing price to household income. The following chart shows the ratio of median home prices and income in the county. Throughout the 1990s that ratio hovered between 3.5 to 4.0. During the boom it spiked to a peak of nearly 8.0 in the 4th quarter of 2005. That bubble was unsustainable and prices have quickly fallen downward. The latest ratio shows home prices are 4.7 times the median income as of the 2nd quarter of 2008, with home prices falling while incomes continue rising.

Housing affordability based on income

Affordability as determined by

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Our rethinking began in March 2008, for in that month there were clear signs that housing was acting as a drag on the region's economy. Revisions of San Diego's 2007 payroll industry employment data by the *California Employment Development Department* that month showed instead of San Diego's job numbers starting to improve toward the end of last year, growth was actually faltering. San Diego's year-over-year job growth in 2008 has subsequently turned negative and as of September, six of the seven past months show annual declines.

More evidence mounted over the summer. As we noted in our July 2008 issue of the San Diego *Economic Ledger,* taxable retail sales in San Diego also turned negative in 2007 (see www.sandiegoinstitute.com/pdf/newsletter/20080701.pdf). Since that time, the report of 3rd quarter 2007 sales released by the *California State Board of Equalization*, shows the slump of local retail transactions deepened.

These two important indications of regional economic activity, along with the continuing slump of housing prices, spreading foreclosures, and a pull back in trade activity – a key driver for the Southern California economy, most certainly point to recession in San Diego. The rest of California, particularly southern California, have also shown similar if not worse job losses and slumping consumer spending as evidenced by retail sales, pointing to California most likely falling into recession as well.

[1]Roger Showley, "Home loan defaults skyrocket in county," *San Diego Union-Tribune*, March 29, 2007.

the *NAHB/Wells Fargo* Home Opportunity Index (HOI) measures the percentage of homes sold in a given area that would have been affordable for a family earning the local median income based on standard mortgage underwriting criteria. The prices of new and existing homes sold are collected from actual court records of sales. Mortgage financing conditions incorporate interest rates on fixed- and adjustable-rate loans reported by the *Federal Housing Finance Board*. NAHB uses conventional assumptions within the lending industry that a family can afford to spend 28 percent of its gross income on housing. The HOI is the share of records in a metropolitan area for which the monthly income available for housing is at or above the monthly cost for that unit.

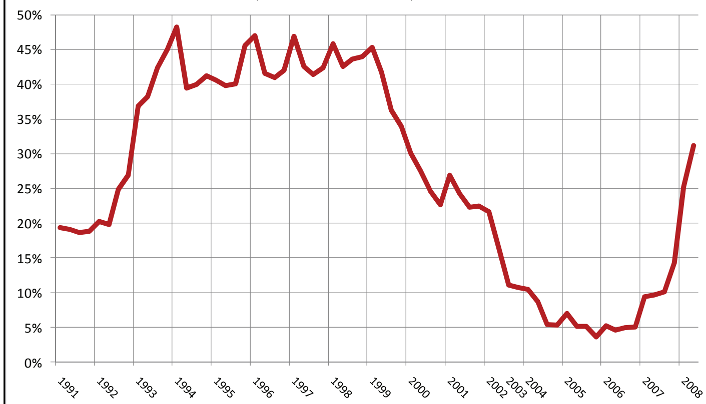
With the high run up in home values, San Diego's housing affordability or opportunity ranking fell to historically low levels of 5 percent and below. San Francisco usually leads as the nation's least affordable housing market. San Diego reached this dubious distinction in the 1st quarter of 2004, but was soon overtaken by Orange County, Santa Barbara, and Los Angeles once their housing prices also spiraled upwards. With home prices falling, San Diego's affordability rating climbed back up to 31.1 percent as of the 2nd quarter of 2008. As the housing slump spreads to the rest of the country, housing affordability in San Diego improved to the best ranking in the 17-year history of the Index. It is critical to note, however, that the region still remains among the lowest in the nation at 203rd out of 222 metropolitan areas ranked.

Expenditure patterns

According to the latest consumer expenditure survey gauging consumer price changes measured by the *U.S. Department of Labor*'s Bureau of Labor Statistics (BLS), San Diego's average household income averages $73,486 per year, 23.8 percent above the national average. Average household expenditures, however, average $62,321 per year, which is 31.4 percent above national averages. To balance family budgets, it means San Diegans typically save less than the rest of the nation.

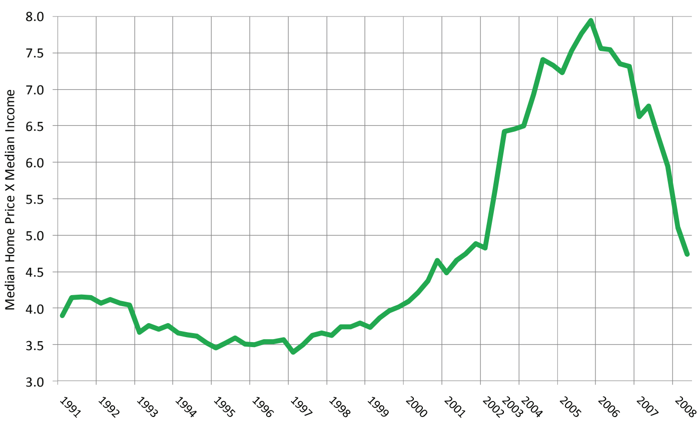
On average San Diego housing costs account for 37 percent of total expenditures, compared to national ratios of one-third (33.3 percent) spent for housing. The subcomponent of housing costs that is comprised of rent or mortgage payments consume on average 25.1 percent of San Diego household's total living expenditures. This cost is only 19.5 percent of a consumer's budget in the rest of the U.S., which indicates San Diegans do not have as much left to spend for other goods and services.

Share of Homes Affordable to Median Income* in San Diego County



*Assumes 10 percent down and 28 percent of gross household income.
Source: National Association of Home Builders. Note: Quarterly survey was not conducted each quarter in 2002-03.

Ratio of Median Home Price to Median Income, San Diego County



Source: National Association of Home Builders. Note: Quarterly survey was not conducted each quarter in 2002-03.

The run up of housing prices in San Diego allowed many to take out second mortgages or equity loans on the basis of perceived value for their home. Creative financing packages also provided an opportunity to buy with low or no down payment, although significant numbers of home buyers took on much more debt. This allowed hard pressed San Diegans to live beyond their means, at least until resetting mortgages and income losses, or both started to occur.

More credit problems

The challenges of higher than average housing costs and incomes that don't keep pace with the cost of living are also reflected in recent statistics released on household debt. *Forbes Magazine* recently found San Diego homeowners are the 3rd most indebted in the nation. Only homeowners in Sacramento and Denver are ranked worse for debt among the nation's 150

National Association of Home Builders/Wells Fargo Housing Opportunity Index: 2nd Quarter 2008

Least Affordable Natl. Rank+	Metro Area	Share of Homes Affordable to Median Income	Median Family Income	Median Home Sales Price
1	New York-White Plains-Wayne, NY-NJ*	11.4%	$63,000	$481,000
2	San Francisco-San mateo-Redwood City, CA*	13.8%	94,300	685,000
3	San Luis Obispo-Paso Robles, CA	14.7%	67,000	420,000
4	Los Angeles-Long Beach-Glendale, CA*	14.8%	59,800	378,000
5	Miami-Miami Beach-Kendall, FL*	17.7%	49,200	295,000
6	Ocean City, NJ	19.6%	65,500	454,000
7	Napa, CA	19.9%	79,600	440,000
8	Santa Cruz-Watsonville, CA	20.2%	79,900	474,000
9	Nassau-Suffolk, NY*	22.1%	97,100	415,000
10	Santa Ana-Anaheim-Irvine, CA*	23.0%	84,100	435,000
11	Salinas, CA	25.8%	64,800	327,000
12	Newark-Union, NJ-PA*	26.5%	84,300	370,000
13	San Jose-Sunnyvale-Santa Clara, CA	26.8%	97,800	515,000
14	Bend, OR	27.6%	58,200	262,000
15	Oxnard-Thousand Oaks-Ventura, CA	30.2%	83,900	390,000
16	Seattle-Bellevue-Everett, WA*	30.7%	81,400	370,000
18	Atlantic City-Hammonton, NJ	30.8%	65,200	278,000
17	Medford, OR	30.8%	50,500	221,000
19	Santa Rosa-Petaluma, CA	30.9%	77,800	356,000
20	**SAN DIEGO-CARLSBAD-SAN MARCOS, CA**	**31.1%**	**72,100**	**342,000**
21	Santa Barbara-Santa Maria-Goleta, CA	31.2%	65,200	315,000
22	Flagstaff, AZ	31.4%	56,700	265,000
23	Madera, CA	31.6%	47,900	213,000
24	Hanford-Corcoran, CA	32.1%	50,100	215,000
25	Mount Vernon-Anacortes, WA	32.5%	59,500	250,000
-	National	55.0%	$61,500	$215,000

+Ranking among 222 metropolitan areas.
*Indicates Metropolitan Divisions. All others are Metropolitan Statistical Areas.
Source: National Association of Home Builders.

largest housing markets.

Forbes used U.S. Census data to determine the highest percentage of outstanding home equity and second loans among the nation's major housing markets. By combining this data with housing price trends taken from the *National Association of Realtors*, they gauged markets experiencing steep home price drops to signify homeowners' level of overextension. Homeowners in areas where prices fell the most were projected to be having the hardest time refinancing or staying afloat. Not being able to refinance makes homes more likely to fall into foreclosure because properties more easily slip into negative equity situations when the property is worth less than the outstanding loan on it.

Home equity loans were highly popular during the housing bubble, especially as the home price market was rising and homeowners were able to take cash out of the value of their home, and deduct the interest. Only when home equity loans, second mortgages and the market fell did things start to fall apart.

In San Diego, 27.5 percent of mortgage holders have either a home equity loan or a second mortgage, or both—among the highest rates in the country. Home equity loans and second mortgages were often taken out for immediate cash or, in many cases during the housing boom, as a way to cover down payments for the home. Borrowers with these "piggyback loans" were thus able to buy homes without putting any money down solely based on credit.

This worked for buyers when home values were rising, but as prices started to fall, these homeowners became particularly vulnerable to foreclosures with no equity in their homes as the market downturn put them upside down or underwater. Slumping home prices mixed with home equity lines of credit and second mortgages also signal a slowdown in the local economy, as loans were often used for home improvements or big-ticket items. This is readily apparent in San Diego with taxable retail sales falling into negative territory starting as early as 2005 after adjusting for inflation, and by 2007 is negative even without considering inflation. As of the 3rd quarter of 2007, retail sales across San Diego County have slumped 4.5 percent from the previous year, despite an increasing population and rising incomes.

Looking forward: Implications for San Diego's future economy

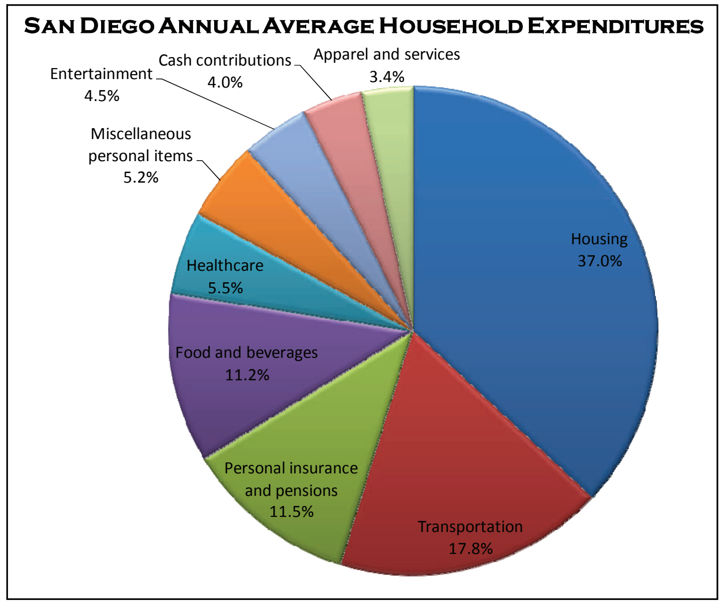
Despite San Diego's economic growth and income increases, housing prices rose beyond local household income to sustain those levels. Debt ratios of San Diego consumers are also compounded by the high cost of living primarily driven by the high cost of housing. The housing market's dysfunction or "irrational exuberance" was primarily due to too easily granted loans for highly inflated home values. The resulting slump of home prices is a market correction bringing home prices back down to more realistic and historic levels compared with area incomes.

As difficult as this is for many who lost or will lose their homes, the contraction is necessary—a counterbalance to the era of easy money and overleveraging. While home values are worth much less than before, prices are more in line with local household incomes. Loans will not be given as freely as before, but will be available to those with good credit and the housing market will be back to normal, at least as normal as it ever is for San Diego.

The fallout from the market correction will leave generally weak economic conditions for San Diego for some time. This portends slower activity not only for the housing market, but lower business activity and sales as consumers adjust to lowered finances and heightened debt levels. With job losses coming about primarily in the construction, real estate and financial sectors, other business activity will also be weak until the housing market stabilizes and debt loads are reduced.

Indicators for San Diego's housing market turnaround

Among many the questions is "when will we know when we hit bottom." It is the opinion of this author that it is important to keep one's eye on five key indicators when seeking to understand when the market is likely to have hit bottom and a stabilization and/or turnaround in housing prices is beginning to occur.



- **Annual payroll job changes** – job numbers vary from month-to-month because of seasonal variations or time of year due to regularly occurring activities such as school sessions, holiday shopping, or weather. Seasonal adjustments and year-to-year comparisons reveal "actual" job changes, which are tracked and reported for San Diego by the *California Employment Development Department*. The website for this data of San Diego is available at:

www.calmis.ca.gov/htmlfile/msa/sdiego.htm

- **Residential construction** – the number of housing units authorized each month for construction reflects the dynamics of the housing market and as previously stated should have some correlation to local job and income changes. The *U.S. Census Bureau* tracks and publishes the number of new privately-owned residential building permits issued each month. This data may be found at:

censtats.census.gov/bldg/bldgprmt.shtml

- **Home sales and prices** – the number of sales as well as price changes show activity in the local housing market. *Dataquick* is a private San Diego-based company tracking actual sales and prices of homes sold collected from county recorder and assessor's records. The data is summarized by zip code in San Diego and published each month at:

www.dqnews.com/Charts/Monthly-Charts/SDUT-Charts/ZIPSDUT.aspx

- **Home values** – since the set of homes sold varies each month, changes in average price may occur because of differences in the types and sizes of houses or changes in the physical characteristics of the homes sold. A measure reflecting the true change in value of housing was developed and calculated each month by *Standard & Poor's* Case-Shiller Home Price Indices. This measure ensures housing values reflect actual market value changes. Twenty metropolitan regional indices are measured each month, including San Diego, published at:

Standard & Poor's Case-Shiller Home Price Indices

- **Housing affordability** – as previously presented here is a measure of the percentage of homes sold in a given area that are affordable to families earning that area's median income during a specific quarter as tracked and published in the *National Association of Home Builders/Wells Fargo* Housing Opportunity Index. San Diego is included in this report each quarter at:

www.nahb. org/ page. aspx/category/sectionID=135

Dashboard Observations—August 2008

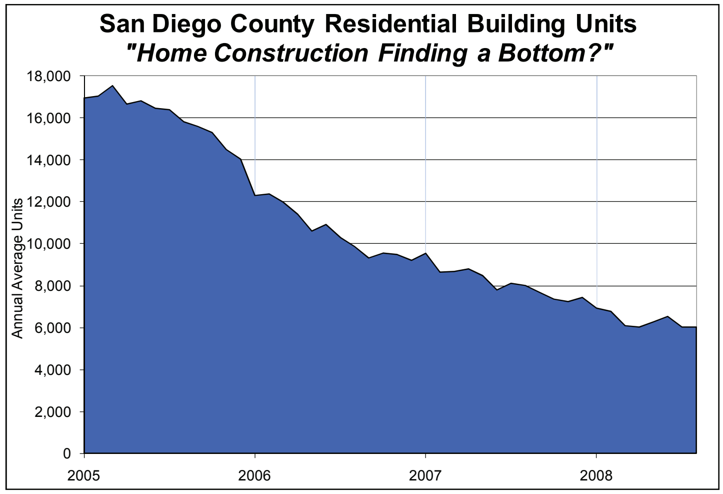
By Kelly Cunningham, Economist, Sr. Fellow

Since a low of 3.7 percent in 2006, San Diego's **unemployment rate** climbed to a high of 6.5 percent in July 2008 and 6.4 percent in August. This is the highest the rate has been since 1995. Critically, at that time San Diego was emerging from the severe '90s recession and the rate was declining (from a high of 8.6 percent reached in 1993). In contrast, the rate is now climbing and probably not yet reaching a plateau.

San Diego's unemployment rate remains more than a full percentage point lower than California's rate of 7.6 percent, but has risen above the national level (except for a few months in 2002) for the first time since 1996. The national unemployment rate was 6.1 percent in August.

Indicator	August 2008	Month Change (Sea. Adj.)	Annual Change
Unemployment Rate[1] San Diego County	6.4%	0.1% ▲	1.6% ▲
Residential Building[2] Units authorized for construction San Diego County	424	18.9% ▲	1.0% ▲
New Business Licenses[3] Issued by City of San Diego	1,508	-19.6% ▼	-34.3% ▼
San Diego Stock Index[4] San Diego based pub. companies 2nd Thursday of month	128.3	11.4% ▲	-1.8% ▼

[1]California Employment Development Department.
[2]U.S. Bureau of the Census.
[3]Business Tax Program, City of San Diego.
[4]Second Thursday of month, Bloomberg News, San Diego Daily Transcript.



Residential building showed improvement in August but remains at historically low levels and it is highly doubtful a bottom to the slowdown has been reached. Since the beginning of the year, the numbers of housing units approved for construction are 25 percent lower than for the same period in 2007, and more than 61 percent lower than in 2005.

New business licenses issued by the City of San Diego in August show a drop in number from the previous two months and from a year ago. The year-to-date number was still positive, however, showing an 11.6 percent increase over the previous year.

The San Diego **stock index** continued to be extremely volatile. The August 2008 index jumped 11.4 percent from July, but was 1.8 percent lower than in August 2007.

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