Pierce's Housing Market Analysis

1997 – 2004: The Bubble and Beyond

by Steve Pierce, 1 March 2004

Introduction

If you own assets, you want to know the value of those assets and how market conditions may affect that value. This helps a prudent manager to develop a strategy, and the curious observer to know "which way the wind is blowing."

With publicly traded stocks you have the convenience of instant access to current value, past value, and future prospects, including price targets. In the rather imperfect housing market, you have the popular press, neighborhood rumors, and open houses. The latter are good for socializing, but not the best for value analysis. The following comments will not necessarily help you assess the value of your home, but hopefully will bring some clarity to what has been a confusing market place.

Over the past few years, we have seen the dot comet rise and fall, and the impact on the real estate market has been fodder for cocktail party tales and financial introspection. Some homeowners have experienced mercurial increases (and decreases) in the value of their homes, while over the same period, others have seen increases without the decreases. The number of homes sold in some areas has been below par, yet we read in the newspaper that 2003 was a banner year for home sales. What is going on?

To assess what the future may hold, it is important to gain understanding of these mixed messages. To that end, it is instructive to look at the market before and after the boom, the 2003 market, current trends, and what all of these may bode for the future.

Looking Back

Over the long run, home values in the Mid-Peninsula region have appreciated about 10% per year. In Palo Alto the multi-decade average annual appreciation has been 10.1%.

Over the past seven years, the average price of homes in Palo Alto has increased by 11% per year, and in 18 other cities in the region by 8% to 12% per year (refer to Figure 1). While this is within the historic norm, what has not been normal is the tumult caused by the run up in values in 1999 and 2000, the ripple effects of which have not fully subsided.

It was during this period that the market took on multiple personalities, and market conditions varied by price point. For clinical purposes there are three "personalities": ultra high-end homes (high \$1M's and up), high-end homes (low \$1M's to high \$1M's), and mid-range homes (low \$1M's and down). (Of course, there is nothing below mid-range, which is a cause of amusement and amazement to anyone not familiar with Bay Area housing prices.)

The cumulative appreciation at various price levels over the past seven years is depicted in Figure 2. The price levels are represented by the average price in representative cities. For example, the average price of a home sold in Atherton in 2003 was \$2.6M, and the Atherton curve represents not only price behavior in Atherton but also price behavior for similarly priced homes in other cities. The figure clearly shows that some homeowners have been on the Materhorn ride while others have enjoyed a peaceful cruise on Its a Small Small World.

Ultra high-end homes saw over 150% appreciation between 1997 and 2000, while the high-end experienced over 100% and the mid-range about 60%. Between 2000 and 2001, values fell significantly (12% to 20%) in the over \$1M world, but only marginally (2% on average) for homes under \$1M. Subsequent to 2001, the under \$1M homes continued the seemingly inexorable climb in value, the value of high-end homes has gone sideways, and the value of ultra high-end homes has continued to drop. The fall for the ultra high-enders was significant between 2001 and 2002 and began to level out between 2002 and 2003.

As depicted in Figure 2, the 1999 to 2000 run-up in values was experienced at all price points. Also, the greater the price, the greater the percentage increase, subsequent decrease, and period of recovery. Why did this occur and what does the data tell us that will help us to better predict future market behavior? Three conclusions emerge: (1) the chronic housing shortage, (2) a temporary shortage of high-end homes, and (3) signs of a return to normalcy.

Chronic Shortage: This region is built-out, and classic supply and demand forces have resulted in a chronic shortage of housing. The long-term robust annual appreciation attests to the lack of supply. In 1999 and 2000, when large numbers of people started to become wealthy, very wealthy, the pressure on the housing market was immediate. (Within weeks after an IPO a company parking lot would transmogrify: Celicas out, Porche Boxters in. Next it was the house purchase.)

Spike in Demand: There were more people with trunks of doubloons than there were high-end houses to accommodate them, and prices rose accordingly. At lower price levels there is more supply, and thus less price pressure. (Nonetheless, many home searchers were unable to find or bid enough to get what they desired. The overflow demand heated up the remodel market, as reflected by decreased contractor availability and increased construction costs.)

Return to Normal?: Figure 2 also shows that the wide variation in cumulative appreciation, nearly 100% in 2000, narrowed to about 10% in 2003. The good news is that this indicates the market has likely stabilized and returned to its traditional rate of appreciation. The bad news is that the annual data does not provide a clear trend line. However, an investigation of the monthly activity in 2003 reveals an interesting transition.

2003

In early 2002 the housing market favored sellers, but in late spring the air went out of the bag and it rapidly shifted to a buyer's market and inventories swelled. This condition continued into 2003. During the first half of 2003, inventories exceeded norms and the number of sales dropped below typical levels. It was a buyer's delight.

In early 2003, the economy started to turn for the better, the stock market was well into its recovery, and interest rates were good and getting better. However, there was also international turmoil in Iraq, which ultimately turned to war, and generally, war does not make people feel good about making major purchases.

However, two events occurred in late spring that changed the complexion of the housing market. The bombs stopped dropping in Iraq in May, and the mantle of the war induced malaise was thrown aside. In addition, the interest rates hit a 40 year low in June and started an abrupt upward trek. Market timing buyers who were waiting for house values and interest rates to bottom out simultaneously suddenly felt that they had missed the Great Convergence and made their move.

As a consequence, the last half of 2003 saw sales increase and inventories decline. By way of example, these changes can be seen in three cities that represent the three price ranges referenced earlier. The inventory during the first half of 2003 in Redwood City was 18% more than typical, in Palo Alto 46%, and in Atherton 61%. At the same time, sales were slightly less than typical in Redwood City and Palo Alto and off 23% in Atherton (explaining the downward pressure on values of high-end homes). During the last half of 2003, the number of sales increased at all price levels and the inventories shrank. The number of sales was 10% to 14% over the norm in the three cities, and the inventory dropped to 5% less than typical in Redwood City, and declined to 4% and 20% more than typical in Palo Alto and Atherton respectively. The markets had shifted to a relatively balanced position.

The volume of transactions is at the yearly low during the holidays (Thanksgiving to Super Bowl Sunday) and starts to ramp-up after the winter hibernation and the potatoes emerge from their couches. The question this year was whether the momentum of late 2003 would carry into 2004.

2004 and Beyond

At the dusk of 2003, all signs pointed to a healthy market in 2004. (I consider a healthy market to be one that does not favor the buyer or seller and where the appreciation of value is in the historic 8% to 12% range). The amount of good economic news was on the upswing, the interest rates retreated, and the stock market remained solid. Early evidence of 2004 suggests that the temperature may be rising quickly, particularly in the under $1.5 market. Multiple offers and overbids have returned.

If too many buyers are chasing too few properties, values will appreciate at a higher than normal rate and buyers will withdraw from the market. The market of 2002 showed that an overheated spring can cool down abruptly.

However, two months a market does not make. January and February are traditionally low inventory months. By March, the market usually reaches average levels for inventories and sales.

Although it may be too early to tell how 2004 is likely play out, I am willing (or perhaps foolish enough) to venture a few projections.

First, as in the recent past, market behavior will vary by price level. In some ways, today's market is the reverse of the 1999/2000 market where demand exceeded supply particularly at the high-end. Currently, the above $2M market has excess supply and, thus, risk of price volatility is low. At lower prices, there is greater risk of imbalance and rapid appreciation.

Second, if the market overheats, it will either (a) self-correct to a balanced position, or (b) overcorrect as it did in 2002, or (c) maintain the overheated condition for an extended period. I believe the former is more likely because:

- The tight supply will ease. More homes come on the market as the year proceeds.
- Buyers perceive that the current interest rates are perishable and therefore have an incentive to stay in the market.
- Memory of the 1999/2000 run-up is fresh, and buyers are unlikely to participate in a similar firestorm.
- Fundamental economic conditions are improving, and it is an election year.

By April, market conditions will be more apparent. During this transitional period of uncertainty, what are buyers and sellers to do? In general, for sellers, there are several reasons why this is a good time to proceed.

- There is currently a shortage of homes at many price levels.
- Interest rates are likely to move upward.
- The most active months for selling, May to August, lie ahead.

For buyers, it is time to proceed with caution. Those wanting a home are faced with what I call the Buyers Conundrum: if one delays their purchase to avoid the multiple offer environment, with typical annual appreciation, today's affordable house may become unattainable tomorrow. The "pullout of the market" strategy is premised on the belief that prices will retreat in the near future. In view of the recent price instability depicted in Figure 2, this might seem reasonable. However, incidents of price depreciation have been rare over the past 50 years.

Thus, because prices may be at the beginning of a sustained upward trend, it is best to stay in the market watching carefully for signs of hyper-appreciation. One's reaction to rapid annual appreciation is a function of the projected holding period. Clearly, the longer the holding period, the lower the risk of losing money. If a buyer expects to own for less than three years, great care is required to avoid near term aberrations. Fortunately, these do not occur often. Except for the 2000 bubble, past periods of rapid appreciation have been followed by periods of slower appreciation and in one case (1990 to 1995) by nominal depreciation.

Historically, the local housing market has been relatively stable, and market tactics have not been critical. However, the volatility of the past five years has taught the need for vigilance and tactical fluidity. Because of today's nonhomogeneous market, strategy should vary by price point.

In summary,

- The effects of the 1999-2000 bubble on pricing appear to have past.
- Despite the bubble, the aggregate appreciation over the past seven years has been in the historically normal range.
- The market shifted from a buyers' to a sellers' market in mid-2003 in all but the highest price ranges.
- The high-end market started to see increased activity in mid-2003.
- Current market conditions vary by price point.
- Homes priced in the low $1M and under are in high demand and short supply and subject to the greatest potential appreciation.

- The relatively low interest rates are likely to fuel the market for months to come.
- It is a good time for buyers and sellers to proceed, but recent market volatility compels buyers to be cautious.

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Zane MacGregor & Co. provides residential real estate brokerage services in the San Francisco Bay Area.

Figure 1

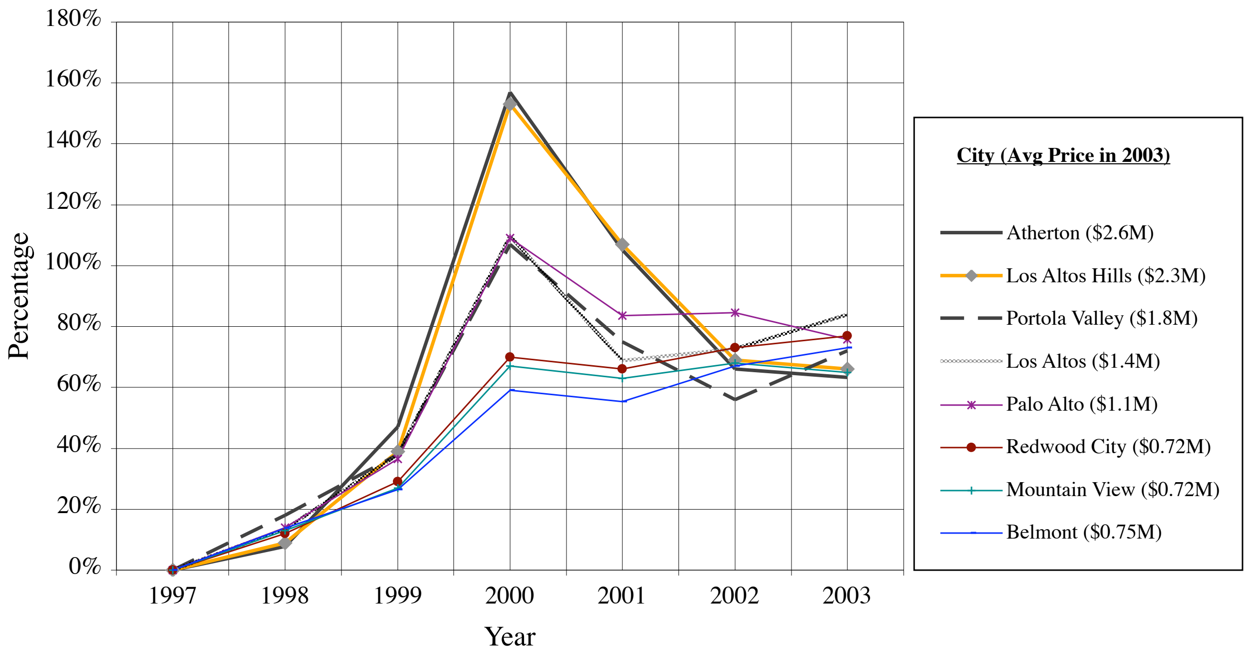
Appreciation in Average Home Price (1997-2003)

City	Appreciation (1997-2003)		Average Price in 2003
	Cumulative	Average Annual	
Ultra High-End			
Atherton	63%	9%	$2,590,000
Los Altos Hills	66%	9%	$2,350,000
Woodside	78%	11%	$2,230,000
Hillsborough	66%	9%	$2,180,000
Portola Valley	72%	10%	$1,820,000
High-End			
Los Altos	84%	12%	$1,360,000
Saratoga	57%	8%	$1,330,000
Los Gatos	74%	11%	$1,120,000
Palo Alto	76%	11%	$1,100,000
Menlo Park	68%	10%	$1,010,000
Burlingame	83%	12%	$1,000,000
Mid-Range			
Cupertino	53%	8%	$840,000
San Carlos	64%	9%	$760,000
Belmont	73%	10%	$750,000
San Mateo	74%	11%	$730,000
Mountain View	65%	9%	$720,000
Redwood City	76%	11%	$720,000
Santa Clara	64%	9%	$620,000
Sunnyvale	74%	11%	$520,000
East Palo Alto	160%	23%	$440,000
County			
Santa Clara Co.	71%	10%	$665,000
San Mateo Co.	72%	10%	$806,000

Source: Compiled by Zane, MacGregor & Co. from information collected by Real Estate Infolink

Figure 2

Cumulative Appreciation of Average Home Price



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