Understanding Today's Real Estate Market

If you are going to target and work with affluent buyers and sellers, provide the information they need, and make your own smart business decisions, it is important that you have a good understanding of what's happening in the real estate market today. Let's go back several years to get some perspective on what created today's market conditions. Here's our view of what happened.

What created today's market conditions?

The conditions leading to the current credit crunch and real estate slowdown are largely a result of a frenzy of demand – demand created by the global investment market and by individual investor/speculators. Beginning in 2000, the world's pool of investment money exploded. In 2000, there was a pool of about $35 trillion dollars invested or seeking investments. But in the short time between 2000 and 2006, that global money pool doubled to about $70 trillion. This translates to a huge number of cash-rich investors -- from pension funds to sovereign funds—all competing for good investments.

Money to spend!

Pools of mortgage loans (mortgage backed securities) have historically been viewed as safe, desirable investments. So, the growth in investment funds meant demand for these investment vehicles soon outstripped supply. Mortgage companies recognized that if they could generate more loans, they could sell them. Wall Street created new ways to package these mortgages, sell them, and pass the benefits and risks on to investors. In addition, more loans supported the political objective of increasing home ownership.

At first it seemed like a win-win. Mortgage money fueled home ownership. The lenders made money, Wall Street prospered and the risk to investors was evaluated based on historical data showing low loan default rates in the U.S. The problem was that in the rush to make more loans, lenders'underwriting requirements slipped. What lenders call "liars loans" became common. These loans required no verification of income or assets. The lender took your word that you had a job and that your income and assets were what you said they were. They simply checked your credit score and made the loan. Adjustable rate loans, interest-only loans, and other loans previously used for special situations, went main stream and were often misused.

This flood of cheap, easy money (designed to produce the maximum number of loans) attracted small investors who decided to join the home buying party. In 2004, a less than terrific stock market caused many investors to look for alternate investments. The California, Florida, Washington D.C. markets (plus a few other major markets) were attractive locations for investment due to strong population growth, healthy job markets, and good overall economic prospects. Investors swarmed into these markets under the assumption that money invested in residences would generate higher returns than the stock market or other investment options. They were right. However, in lock step with investors, came swarms of speculators (we're defining speculators as investors who really couldn't invest without special financing). The low underwriting standards allowed them into the market.

The demand created by these two groups created a buying environment in these targeted markets where flipping became the norm. It ceased to matter whether a property would cash flow or even be rented. There were quick profits to be made. Return-on-investment was high. Strong demand allowed investors and speculators to contract for a property with a small deposit and sell the property at a profit prior to closing. Others bought, held briefly, and resold for more money. Price appreciation soared with the demand. Developers and builders followed the money and inventories began to rise.

2005: The frenzy moved to new markets

By 2005, many savvy small investors felt the top markets of 2004 offered less opportunity and they looked for new markets where economic fundamentals were good and prospects for home appreciation were strong. In short, they wanted to duplicate the smart investments of 2004 in new markets. This shift or "spillover" into new markets like Phoenix/Scottsdale (AZ), Las Vegas (NV), Reno (NV), Seattle (WA), and Cape Coral (FL), created new demand in these markets. Speculators followed, as did builders and developers. Second home buyers also jumped into the fray, adding to the demand. Government homeownership programs encouraged those at the bottom of the economic pyramid to buy. Money was fueling the market. Homeowners who didn't want to sell, refinanced instead using the high valuations on their homes to take out cash. Home equity was used like cash from an ATM machine to fuel consumer purchases contributing to a more robust economy. The total number of loans soared.

During 2005, almost 40% of all home buyers were investor/speculators or second home/vacation buyers (27.7% & 12.2% respectively). The difference between the two is primary intent. Investors were looking for return on their investment, while second home buyers' primary motivation was to use a property as a residence. Appreciation soared in these spillover markets in 2005. For example, Phoenix/Scottsdale prices jumped almost 40% in 12 months.

This was not a normal market, nor one which thoughtful observers would expect to continue. Bubbles were being formed. However, the housing boom was an economic engine and everybody wanted onboard. Anyone looking closely at the situation should have seen trouble on the horizon. But, consumers were getting dream homes, lenders and Wall Street were raking in profits, homeownership was growing, industry job creation was strong, old statistics promised the investments were safe, and regulators must have been dozing.

2006: The real estate market slowed

By 2006, some home owners began having difficulty making their loan payments as loans ballooned or rates clicked up. When lending practices began to tighten in 2006 and some loans had significant rate adjustments, there were fewer qualified buyers and more available inventory, so market conditions changed. Many buyers found themselves with properties they couldn't afford and loans that were upside down – more was owed on the properties than they were worth. There were fewer investors pursuing residential investments and those that were out there shifted their target markets looking for new opportunities for good returns. Speculators began to fall out of the market.

In 2006, 36% of buyers fell into the investor/speculator or second home buyer category. The percentage of investors had declined to 22%, while the percentage of second home buyers had increased to 14%. Despite the overall slowdown, there were still some markets with good appreciation (investor/second home buyer demand, a booming oil business and Katrina relocations all being important factors). Top appreciation rates in 2006 were about half of what they'd been in 2005. Overall, national home sales slipped 10.8% in 2006, compared to the previous year. However, mortgage securities were still a hot commodity.

2007 and 2008: The slowdown continued

By 2007, the downturn in housing had gained momentum. Lenders were facing a secondary loan market which was becoming a bit more selective about loan purchases. Money was getting tighter. Job losses and other economic issues in markets like Cleveland and Detroit contributed to the slowdown. By the end of the year, The National Association of REALTORS® reported that the housing market was off by 12.8% compared to 2006 (which, remember was already down about 10% compared to 2005). The new home market had suffered even more, falling a whopping 26%, according to The National Association of Home Builders.

2008 brought a serious "credit crunch." The creative packaging of loans into new forms of mortgage securities, (which had fueled the market by keeping money flowing for home investment) suddenly became a more visible problem. As buyers defaulted, the value and marketability of the mortgage securities became questionable. The financial market took a closer look at these securitized mortgages and realized that ratings based on old underwriting standards were irrelevant and the risks were significantly higher than projected. Defaults and foreclosures soared, home inventories rocketed up, and home prices softened. Available money dried up and the financial market faced liquidity and solvency issues. The bubble had burst. The loan frenzy was over, leaving an industry questioning how to deal with the resulting problems.

So what's ahead? With money tighter, home inventories high, an economy that is either in or on the brink of recession, a weak U.S. dollar, and lower demand for housing, it seems safe to assume that the short term economic news is not good for residential real estate. We have not yet seen the full extent of problems in the housing market and may soon have to deal with similar problems with auto loans and credit card debt. It will probably take the rest of 2008 and all of 2009 before we work our way out of the housing downturn.

The luxury market continues to perform well

It's not all doom and gloom. The top of the market continues to be healthy. Many of the country's most affluent zip codes are still enjoying price appreciation. Recent research by The Harrison Group for American Express revealed that the affluent view today's real estate market as an opportunity. In fact, those who earn at least $500,000 annually not only see an opportunity, they plan to buy residential real estate in the next 12 months. Of the 40% who report buying plans, the majority say their planned purchase will be a second or third home. This demand will be supplemented by wealthy international buyers view our residential properties as "on sale" and are continuing to purchase in many major markets.

Bottom line – the market overall is soft and will be for awhile; however, the top of the market is out performing other segments.

Source: The Institute for Luxury Home Marketing, 2008