Home Price Analysis for Los Angeles Region

By the Research Division of the National Association of REALTORS®

Executive Summary

- Home prices in the region continued to increase strongly in the first quarter of 2006, posting a 19% gain. The outsized gain is on top of 81% three-year cumulative increase from 2002 to 2005.

- Home sales, straining under the weight of higher mortgage rates, have declined recently and so inventory has increased. Sales are down in California by almost 20% and by even more in the higher-priced major coastal cities in the state.

- Because of the strong rise in home prices over the past three years, mortgage debt servicing costs have risen significantly. In the first quarter of 2006, the debt service cost relative to household income was 45% -- well above the national average of 22%.

- A recent cut-back in new home building has reduced the risk of overbuilding in the region. Homebuilders evidently are responding to reduced housing demand. Low new supply better helps support home prices.

- The use of adjustable-rate mortgages (ARMs) remained elavated in the first quarter as 63% of new loans were ARMS - a percentage essentially unchanged from a quarter earlier and up from 52% a a year earlier. Though ARMs are the best financing choice for some homeowners, ARMs also carry interest-rate risk. The high use of ARMs raises regional risk of defaults and financial strain.

- The percentage of homebuyers who utilized sub-prime mortgages (those with rates more than 3 percentage points higher than the average market rate) was much lower in the region compared to the nation as a whole. Also, a significantly lower percentage of mortgages was used to buy second/investor homes. Such conditions bode well for lowering risks associated with foreclosures and quick sales.

- Local job growth has been respectable. The three-year job growth of 1.4% is below the national average, but the local unemployment rate of 5.0% in the first quarter implies near full employment in the region. Not surprisingly, the mortgage delinquency rate in the first quarter for the state was well below the national average.

- Job growth attracts additional potential homebuyers to the market and limits the number of "forced-home sales" (as was the case in the early 1980s and 1990s). This suggests that any price decline will likely be short lived given the additional buyers ready to enter the market.

- However, the biggest risk is the drastic slowdown in home sales activity that would result from even further measurable increases in interest rates. Should the 30-year average fixed rate approach 7.5% its current 6.8%) as a result of too much monetary tightening by the Federal Reserve, home prices in the region could well decline.

Summary of Activity

	Los Angeles	National Average	Comment
Price Activity			
Latest Appreciation (2006 Q1 vs 2005 Q1)	19.1%	10.3%	Strong
Last Year Appreciation	18.0%	12.0%	Strong
3-year Appreciation	81.1%	31.0%	Strong
Historical Average Annual Appreciation*	7.5%	5.0%	Strong
Affordability			
Mortgage Debt Servicing Cost to Income Ratio** (2006 Q1)	45.1%	22.0%	Very High
Historical Mortgage Debt Servicing Cost*	33.3%	22.0%	High
Home Sales			
State Existing Home Sales (2006 Q1 vs 2005 Q1)	-19.2%	-2.1%	Unfavorable
Single-family Housing Permits (2006 Q1 vs 2005 Q1)	-4.0%	-0.9%	Neutral
Mortgages			
Share of New Loans with ARMS (2006 Q1)	63.0%	28.0%	High
Share of New Loans with LTV higher than 90%	1.0%	16.0%	Favorable
Percentage of Sub-Prime Mortgages	8.6%	10.1%	Neurtral
Percentage of Mortgages for Second Home Purchase	10.1%	15.3%	Favorable
State Delinquency Rate (2006 Q1)	1.8%	4.0%	Favorable
Local Fundamentals			
3-year Job Growth	1.4%	2.4%	Neutral
Unemployment Rate (2006 Q1)	5.0%	4.7%	Neutral
Housing Permits to Total Employment (2005)	0.5%	1.6%	Favorable
Net Migration	-72,100	0	Unfavorable

Risk Factor

Rather sharp declines in sales in recent months have increased the number of homes on the market. Further declines could be expected if mortgage rates inch even higher. But the decline in sales should finally take pressure off home price growth (though the latest data continues to show a near double-digit appreciation). The mortgage debt service cost of buying a median priced home has greatly increased in the past three years. The negative net migration (the net flow of U.S. residential movements, which excludes immigration) may partly reflect homeownership difficulty in the metro market. However, a low ratio of housing permits to employment implies no oversupply in the market. The very low share of loans with high LTVs implies minimal financial strain even if prices were to decline over the short-term.

** Average ratio from 1980 to 2005*

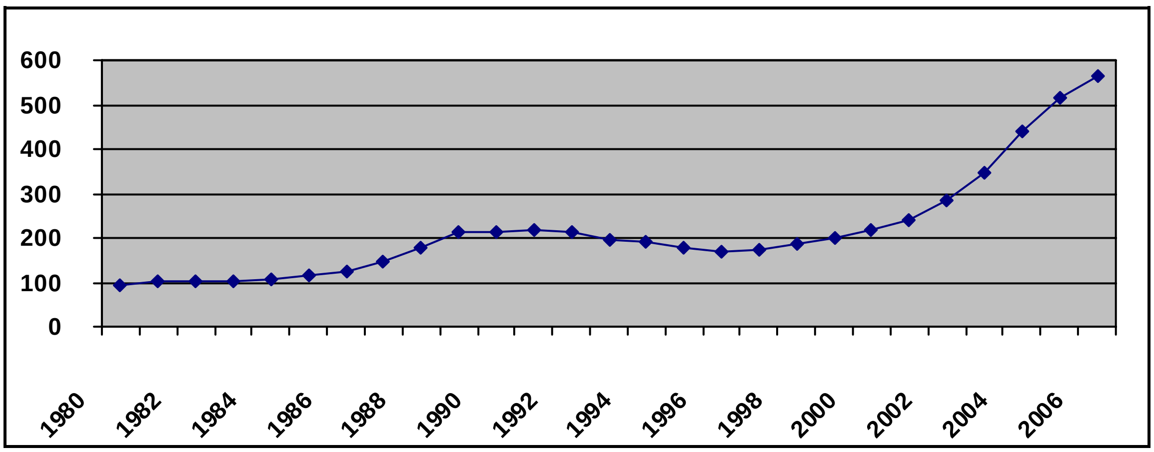
*** This ratio compares the monthly mortgage payment for a median-priced home financed at the prevailing mortgage rate to the median household income.*

Price Activity

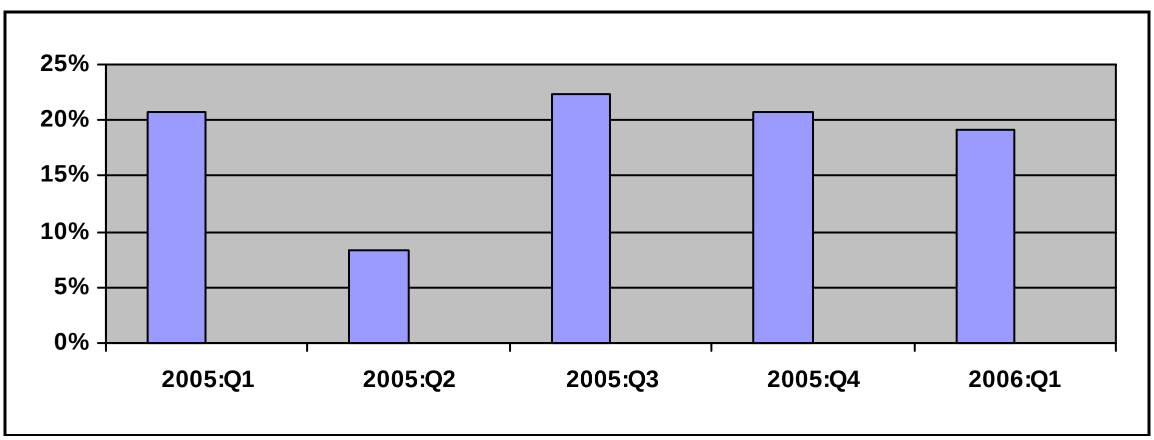
	Existing Home Price	Price Growth	Local to National Price	Per Capita Income	Mortgage Servicing Cost to Income	12 month Job Gain
2001	240,100	11.1%	1.5	32,152	24.0%	26,300
2002	285,800	19.0%	1.7	32,522	27.0%	-56,800
2003	347,500	21.6%	1.9	33,318	29.0%	-18,700
2004	438,400	26.2%	2.2	35,188	35.0%	42,100
2005	517,500	18.0%	2.4	36,771	40.0%	53,600

- Last year was another strong year, with the median home price rising 18.0% to $517,500.
- Prices continued to show strength in the first quarter of 2006, with no sign of deceleration despite slowing sales activity. Prices rose 19.1% in the first quarter compared to one year ago. (See chart below.)
- If history is a guide, the robust job gains of 53,600 net new jobs in 2005 and 65,400 in the 12 months from May 2005 to May 2006, will keep home prices from falling.
- Home prices were relatively flat for most of the 1990s. So part of the recent years' increases are attributable to the "catch-up" effect.

Local Home Price (in $1,000)



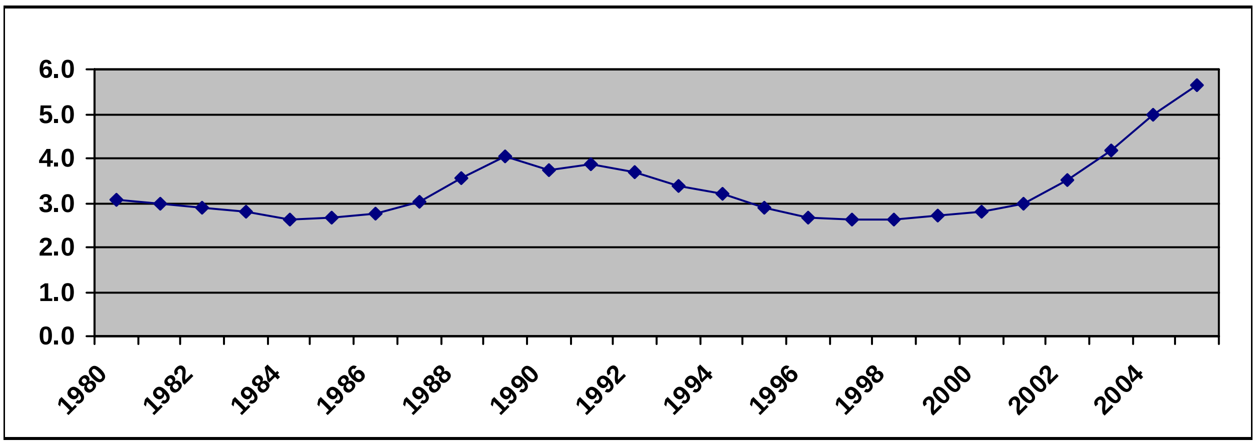
Recent Price Appreciation



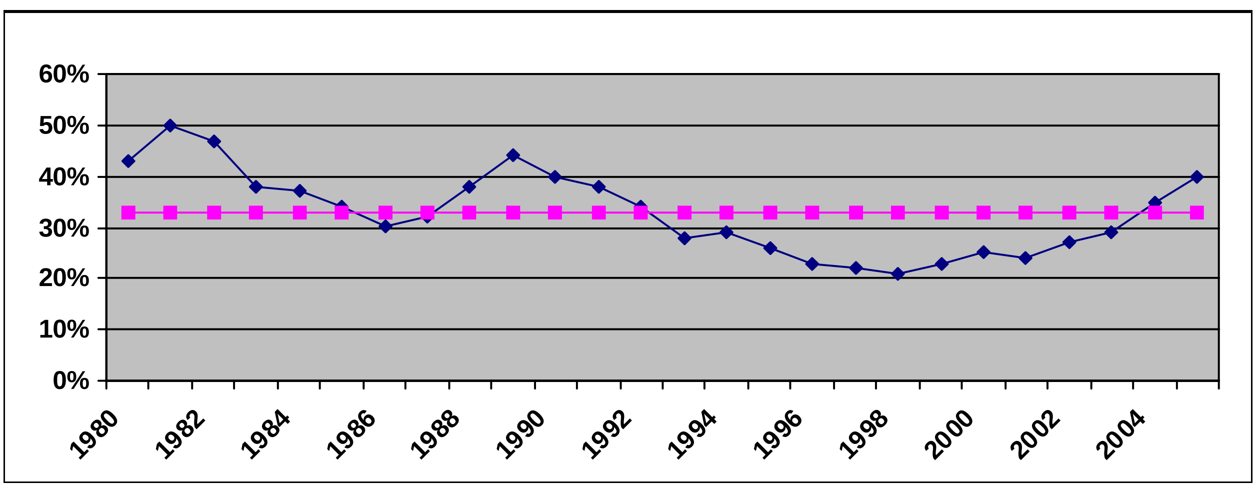
Affordability

- Because home prices have risen faster than income, the ratio of price-to-income is currently above the historical norm. This measure is frequently cited to imply that there is a housing market bubble.
- A more relevant measure for assessing the risk of a home price bubble is the median mortgage servicing cost relative to the median income. This ratio has also risen despite mortgage rates at near historic lows.
- Nonetheless, the mortgage debt servicing costs is still below the peak levels seen in the early 1980s. Also, as mentioned, jobs are being created in the region, thus alleviating some of this concern.

Price to Income Ratio



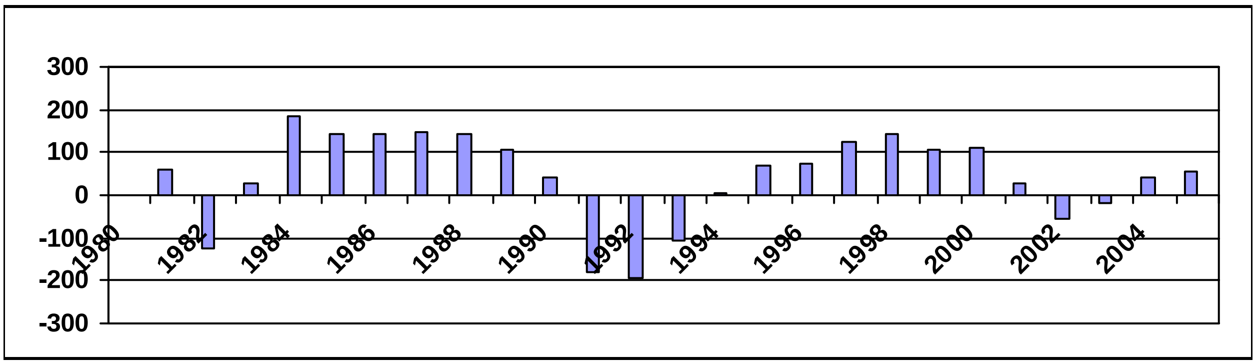
Mortgage Servicing Cost to Income Ratio
(Historical average shown as square boxes)



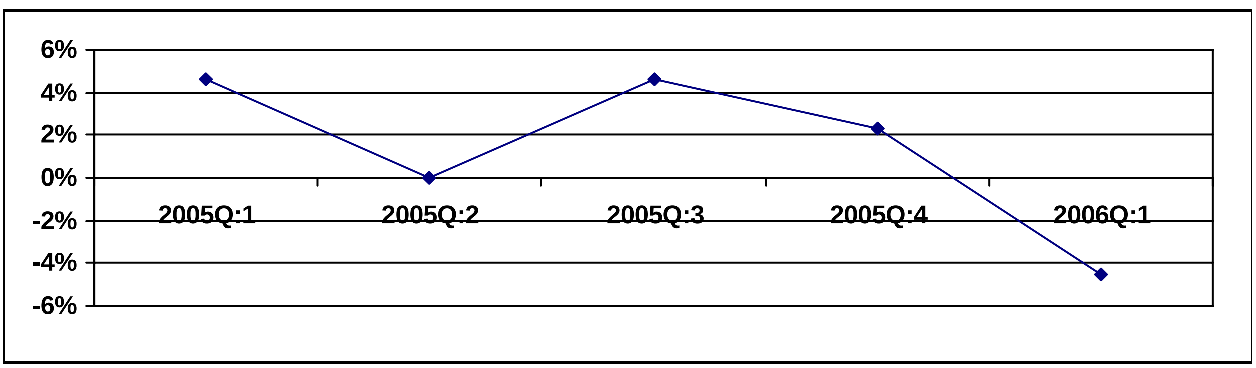
Local Fundamentals

- Job gains have been robust in the last five years. A total 47,000 jobs were added during that time. Many new job holders seek their own housing units.
- Over that five-year period, the region added only 107,700 new housing units, of which 51,000 were single-family units.
- New home construction declined in the latest three quarters - a supply reduction, which helps support home prices.
- The ratio of five-year job gains to five-year new home construction shows the "hangover" impact of a housing shortage or housing surplus. Based on this measure, the market appears fairly neutral.

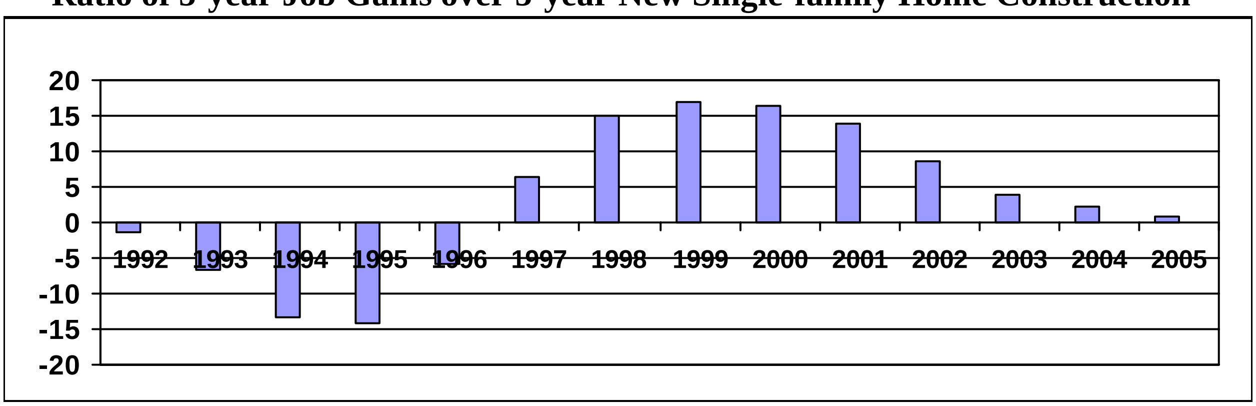
Job Gains (in Thousands)



Recent new Single-family Home Construction
(% change from a year ago)



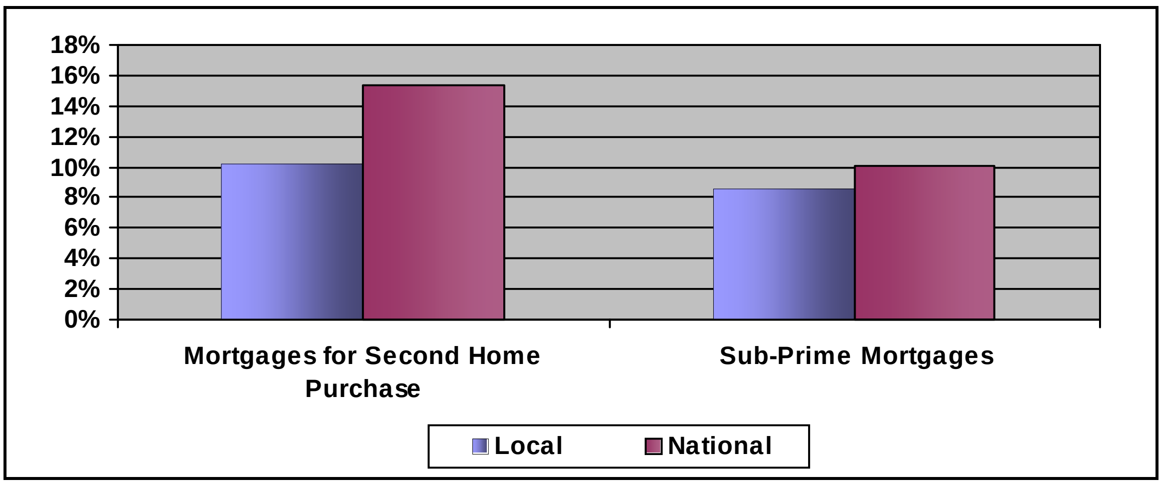
Ratio of 5-year Job Gains over 5-year New Single-family Home Construction



Mortgage Activity

- Mortgage lending in the region has been primarily to owner-occupied, credit-worthy borrowers who are least likely to quickly "dump properties" onto the market. The percentage of sub-prime loans (those carrying interest rates at least 3 percentage points higher than market rates) was 9%. Also, only 10% of the loans were for non-owner-occupied properties.
- The share of adjustable-rate mortgages was 63% in the first quarter of 2006. Also, only 1% of new loans had a loan-to-value ratio of greater than 90%. Therefore, prices would have to decline by far more than 10% to have a measurable impact on foreclosure rates.
- Baby boomers are in their peak earning years and have been active in purchasing second homes, which many consider as their future retirement homes. The baby-boomer impact will continue for another 10 to 15 years.

Riskier Mortgages



Prevalence of Riskier Mortgages

(Unit: Percentage)

Quarter	Adjustable New Loans	Loans with LTV over 90%
2005:Q1	52	3
2005:Q2	52	3
2005:Q3	56	3
2005:Q4	64	2
2006:Q1	63	1

Price Scenarios

- Even in the unlikely event of prices declining by 5%, most homeowners will maintain sizable equity build-up in their homes. The table below shows the home equity gains if prices were to fall by 5% in 2006. A homebuyer who purchased in 2005 would suffer $19,200 in home equity loss. But homebuyers who had purchased in prior years would still retain significant housing equity gains.

Year of Purchase	Housing Equity after 5% Price Decline (Home price appreciation + principal payments on mortage)
1980	$452,700
1985	$414,300
1990	$325,400
1995	$340,800
2000	$289,400
2001	$266,200
2002	$220,300
2003	$158,500
2004	$65,000
2005	($19,200)

- A likely scenario is for home prices to rise, though at a much lower rate than in recent past years. The equity gains under different though conservative price growth assumptions are presented below.

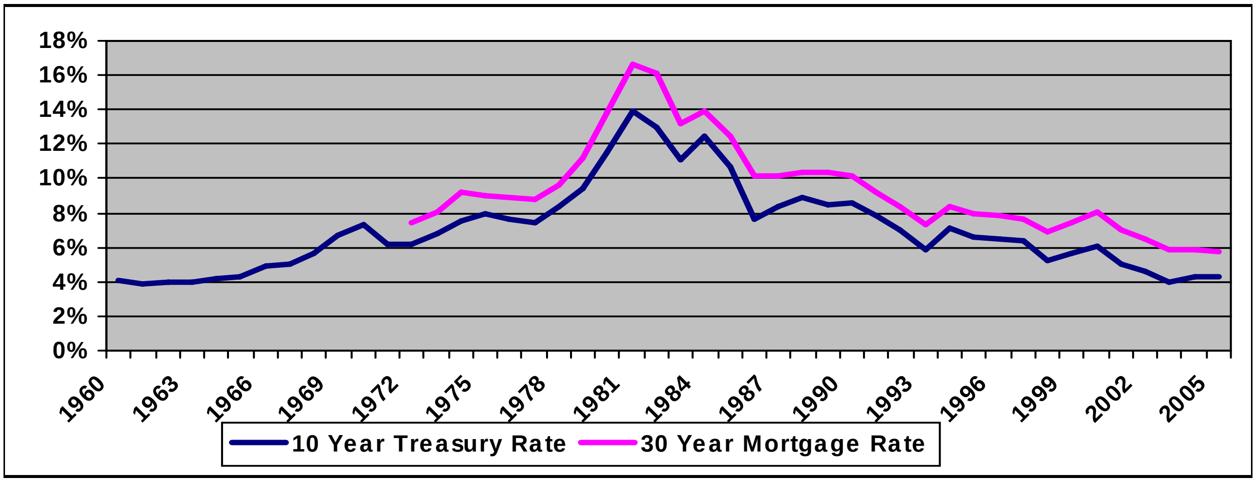
Housing Equity Gain				
Appreciation Rate	***1.5%***	***3.0%***	***4.5%***	***7.5%***
Conservative Scenarios	***Low***	***Middle***	***High***	*25-year average rate*
2010	$77,300	$119,700	$164,700	$261,400
2015	$167,200	$262,100	$370,200	$629,400
2020	$278,800	$438,100	$633,300	$1,155,100
2030	$590,000	$922,600	$1,394,400	$2,967,600
2040	$871,400	$1,456,200	$2,415,400	$6,425,400

Additional Discussion Points

- Home price declines are very rare. In fact, the national median home price has not declined since the Great Depression of the 1930s. Stock market collapses, OPEC oil crunch, economic recessions, and even wars have not negatively impacted national home prices since the 1930s.
- There have been few times when local prices declined. In nearly all these cases, the price declines were accompanied by sharp prolonged job losses. It is difficult to foresee a price decline in a job creating economy.
- Homes trade far less frequently than financial assets (about one home sale every 7 to 10 years for most homeowners). There are also larger transaction costs associated with selling a home due to the lengthy careful examination demanded by home buyers and sellers. Therefore, home prices are not prone to fluctuations as in the stock market. There are neither panic sells nor margin calls associated with homes.
- Many non-quantifiable factors could be important for this metro market in determining home prices. Access to cultural life, the quality of museums, nearby local and national parks, water views, exclusive neighborhoods, weather, the international airport, city vibrancy, restaurants, and a host of other non-quantifiable factors could have an important influence on the overall pricing.
- There are immense tax benefits to owning a home. These tax considerations were not considered in the analysis. For example, the 1997 law permitting primary owner occupants to trade down without having tax consequences. Also most home sales results in no capital gains tax. In addition, long-term capital gains tax rates were reduced in 2003, thereby providing higher return for home investors. These positive benefits, if accounted for in the analysis, would have shown an even stronger case for housing fundamentals in supporting home prices.

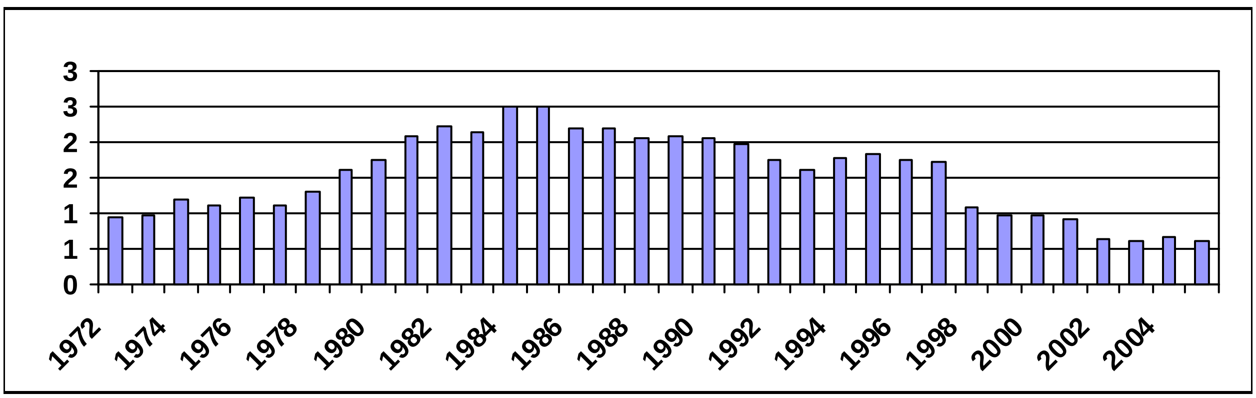
Additional Informative Charts

45-year Low Mortgage Rates



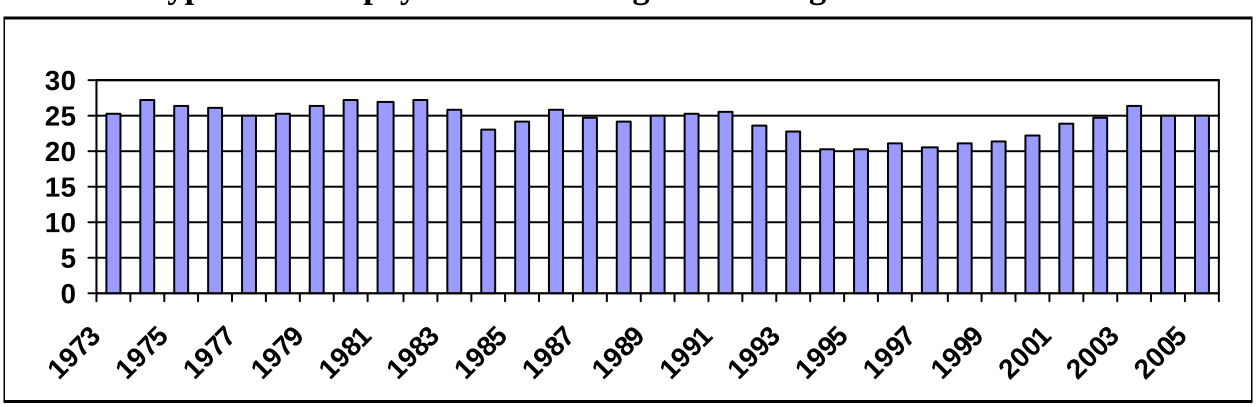
Source: Freddie Mac, Federal Reserve

Historic Low Fees and Points for Mortgage Origination



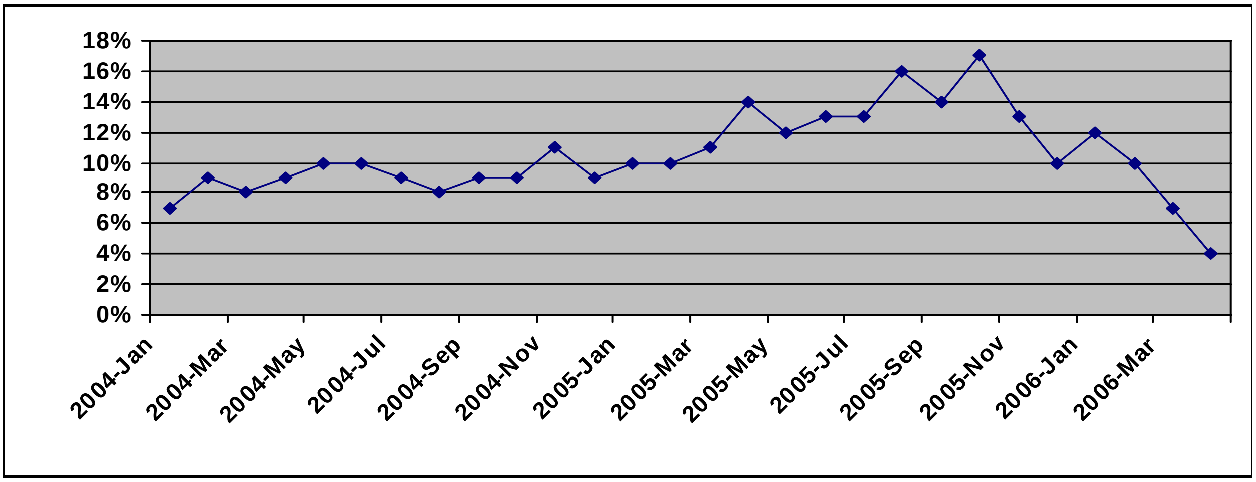
Source: Freddie Mac, Federal Reserve

Typical Down-payment Percentage Returning to Historic Norms



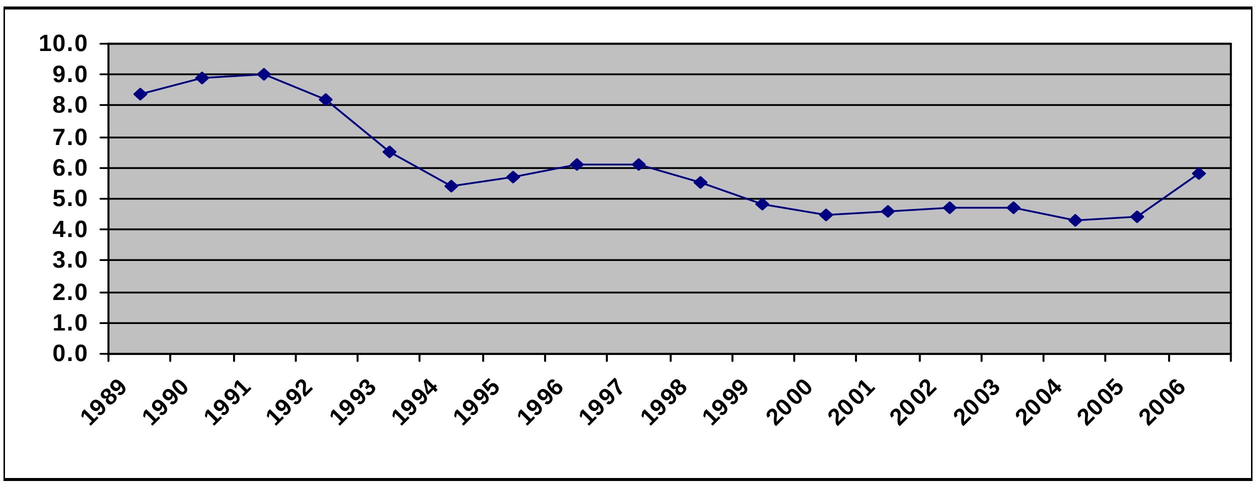
Source: Federal Housing Finance Board

Recent National Price Deceleration



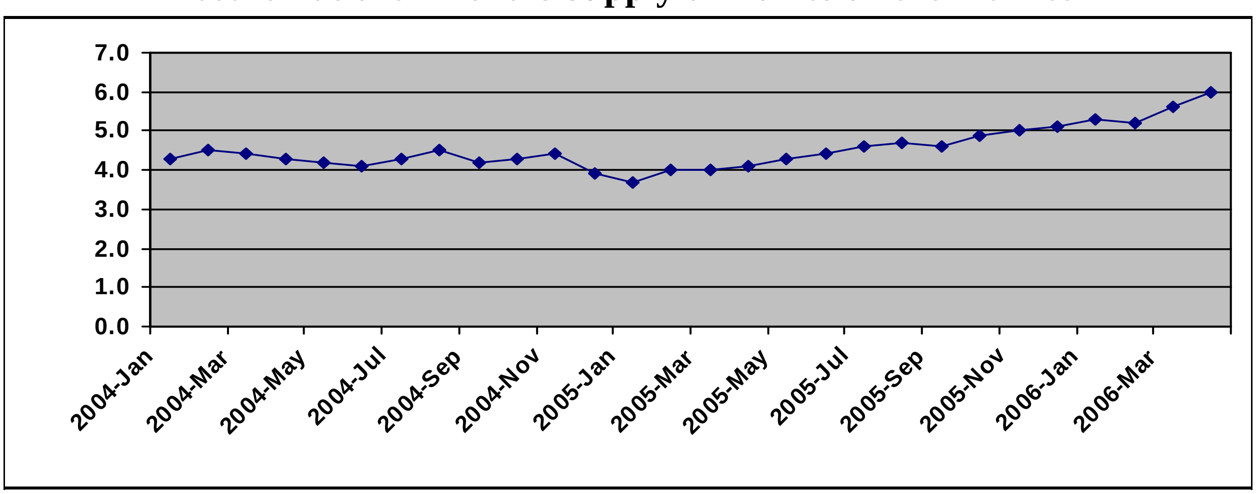
Source: NAR

Historical National Months Supply of Homes on the Market



Source: NAR

Recent National Months Supply of Homes on the Market



Source: NAR

NAR Research

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