Home Price Analysis for Riverside Region

By the Research Division of the National Association of REALTORS®

Executive Summary

- Home prices in the region continues to move strongly in the Riverside-San Bernardino region. After posting five straight years of double-digit gains, including a whopping 36% one year appreciation in 2004, prices rose 15% in the first quarter of 2006 from a year ago.

- Higher mortgage rates, which have risen roughly one percentage point since last summer, have only modestly dampened price growth. The relatively affordable conditions in the inlands in comparison to the coastal counties of Los Angeles, Orange, and San Diego have attracted new residents to the region.

- Because of the strong increase 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 43% -- well above the national average of 22%.

- Homebuilding has been robust in recent years, but builders need to be cautious of not oversupplying the market.

- A significantly higher percentage of mortgages was used to buy second/investor homes. Such conditions could lead to quick sales and market fluctuation.

- The percentage of homebuyers who utilized sub-prime mortgages (those with rates more than 3 percentage points higher than the average market rate) was about the national average.

- Local job growth has been exceptionally strong. The three-year job growth of 14.3% is more than five times as fast as the national increase. The local unemployment rate of 5.0% in the first quarter of 2006 implies 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 could result from further measurable increases in interest rates. Should the 30-year average fixed rate approach 7.5% (from 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

	Riverside	National Average	Comment
Price Activity			
Latest Appreciation (2006 Q1 vs 2005 Q1)	15.4%	10.3%	Strong
Last Year Appreciation	25.5%	12.0%	Strong
3-year Appreciation	111.9%	31.0%	Strong
Historical Average Annual Appreciation*	7.2%	5.0%	Strong
Affordability			
Mortgage Debt Servicing Cost to Income Ratio** (2006 Q1)	43.3%	22.0%	High
Historical Mortgage Debt Servicing Cost*	29.1%	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)	0.0%	-0.9%	Neutral
Mortgages			
Share of New Loans with ARMS (2006 Q1)	NA	28.0%	NA
Share of New Loans with LTV higher than 90%	NA	16.0%	NA
Percentage of Sub-Prime Mortgages	10.4%	10.1%	Neutral
Percentage of Mortgages for Second Home Purchase	18.2%	15.3%	Unfavorable
State Delinquency Rate (2006 Q1)	1.8%	4.0%	Favorable
Local Fundamentals			
3-year Job Growth	14.3%	2.4%	Favorable
Unemployment Rate (2006 Q1)	5.0%	4.7%	Favorable
Housing Permits to Total Employment (2005)	4.2%	1.6%	Unfavorable
Net Migration	91,400	0	Favorable

Risk Factor

Rather sharp declines in sales in recent months in the nearby coastal regions could spread inland. 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 strength). The mortgage debt service cost of buying a median priced home has greatly increased in the past three years. The positive net migration (the net flow of U.S. residential movements, which excludes immigration) reflects more affordable conditions in the region compared to LA or Anaheim.

** Average ratio from 1980 to 2005*

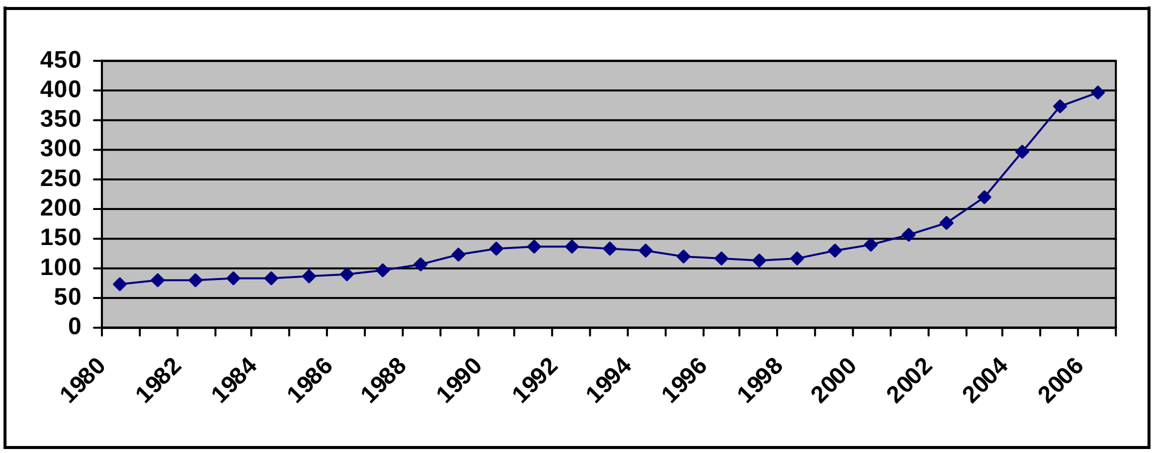
*** This ratio compares the monthly mortgage payment for a median-priced home financed at the prevailing mortgage rate to the median household income.*

Price Activity

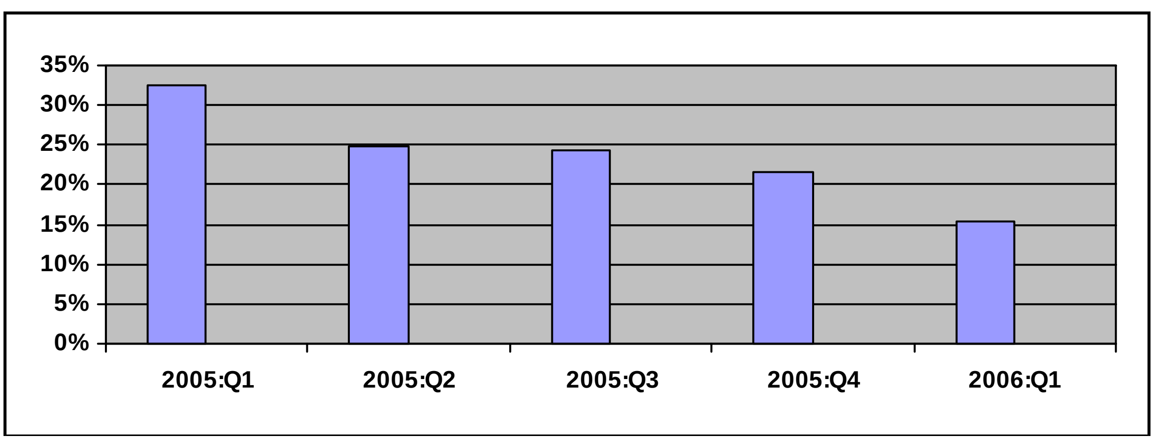
	Existing Home Price	Price Growth	Local to National Price	Per Capita Income	Mortgage Servicing Cost to Income	12 month Job Gain
2001	155,800	12.4%	1.0	23,773	21.0%	41,300
2002	175,900	12.9%	1.0	24,021	22.0%	34,800
2003	218,900	24.4%	1.2	24,499	25.0%	34,700
2004	296,900	35.6%	1.5	25,769	32.0%	60,800
2005	372,700	25.5%	1.7	26,929	39.0%	57,100

- 2005 was another strong year, with the median home price rising 25.5% to $372,700.
- But the first-quarter 2006 price appreciation slowed somewhat to 15.4%. (See chart below.)
- If history is a guide, the robust job gains of 26,200 net new jobs in the past 12 months 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)



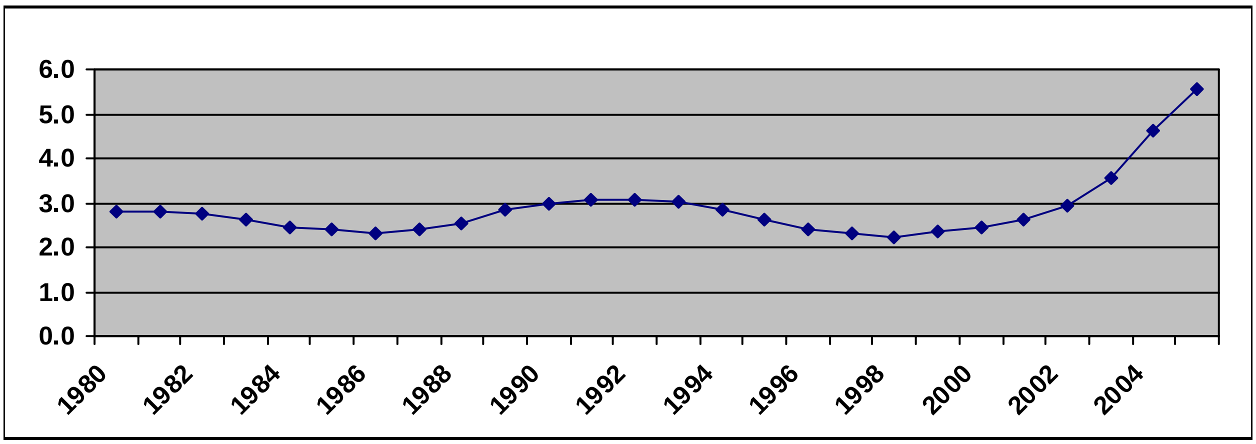
Recent Price Appreciation



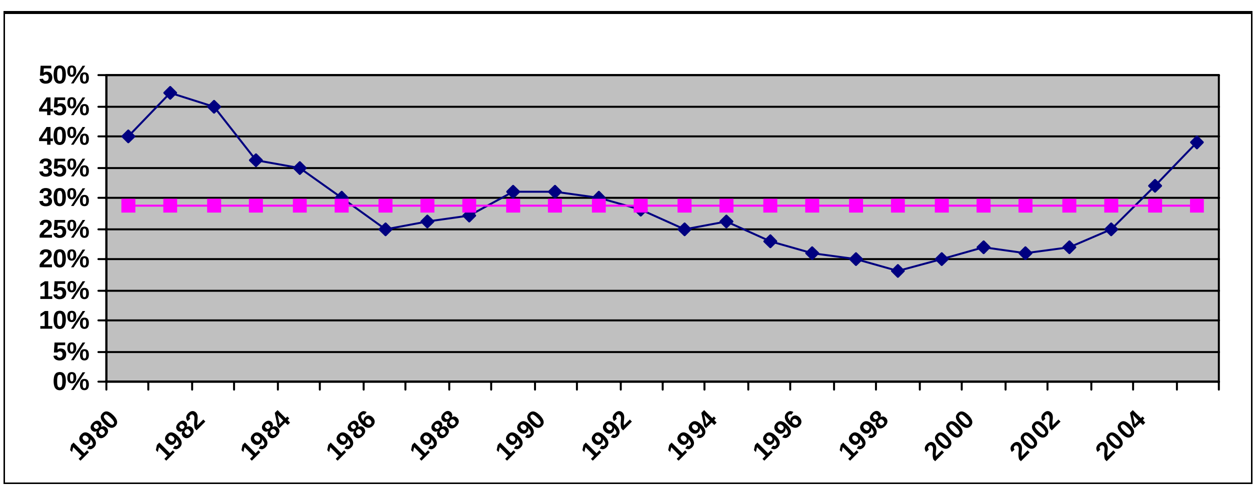
Affordability

- 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.
- However, mortgage rates declining to historic lows have been a major force in boosting home prices in recent years. Recent higher rates are still at historically favorable levels. Lower rates allow homebuyers to obtain a larger loan without necessarily increasing monthly mortgage payments.
- 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, but not to alarming levels.

Price to Income Ratio



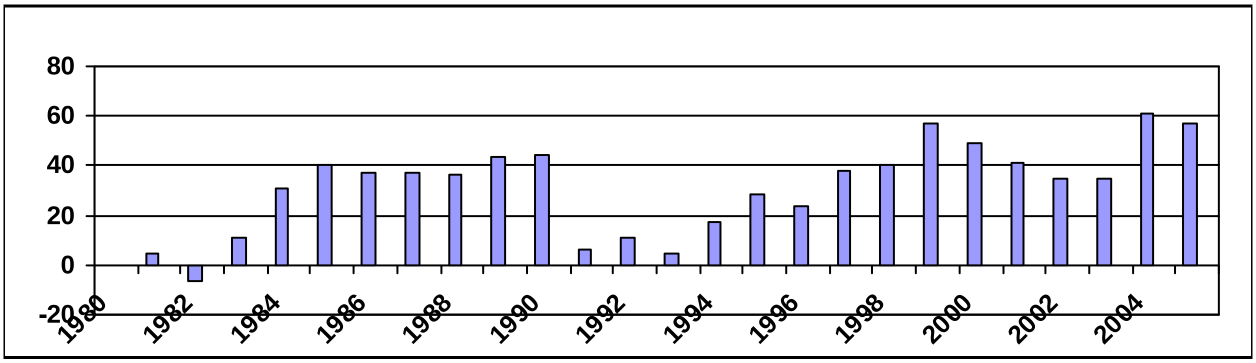
Mortgage Servicing Cost to Income Ratio
(Historical average shown as square boxes)



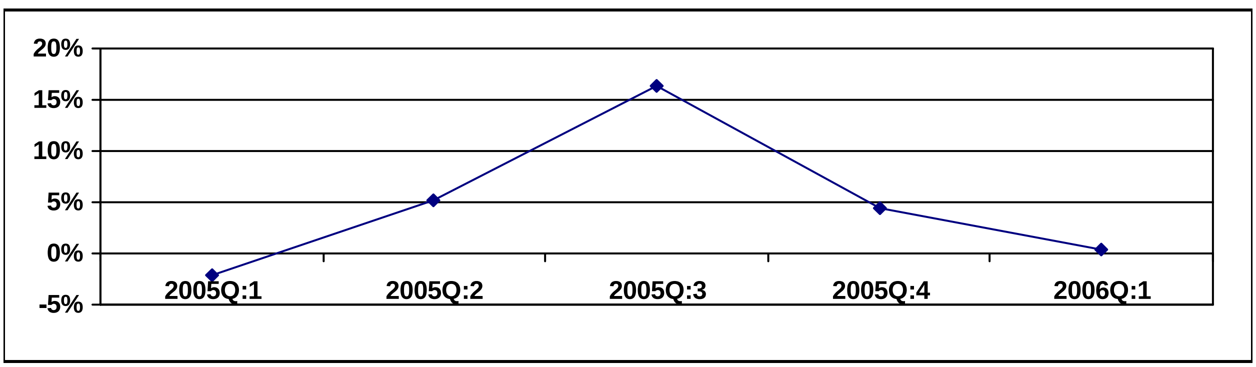
Local Fundamentals

- Job gains have been robust in the last five years. A total 229,000 jobs were added during that time. Many new job holders seek their own housing units.
- Over the same time period, the region added 203,500 new housing units, of which 177,700 were single-family units.
- New home construction have been rising in recent quarters. A supply increase helps moderate home price growth.
- 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, there were more new job additions than new housing additions.

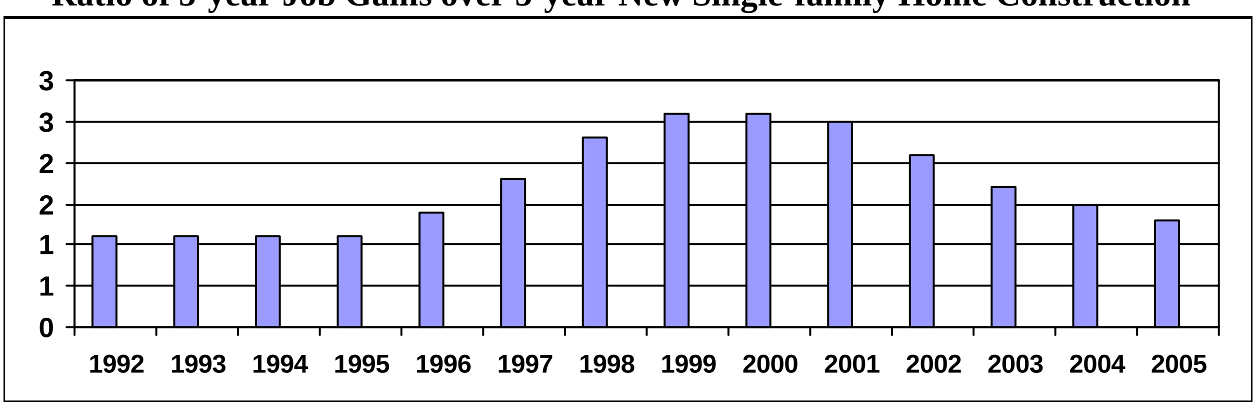
Job Gains (in Thousands)



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



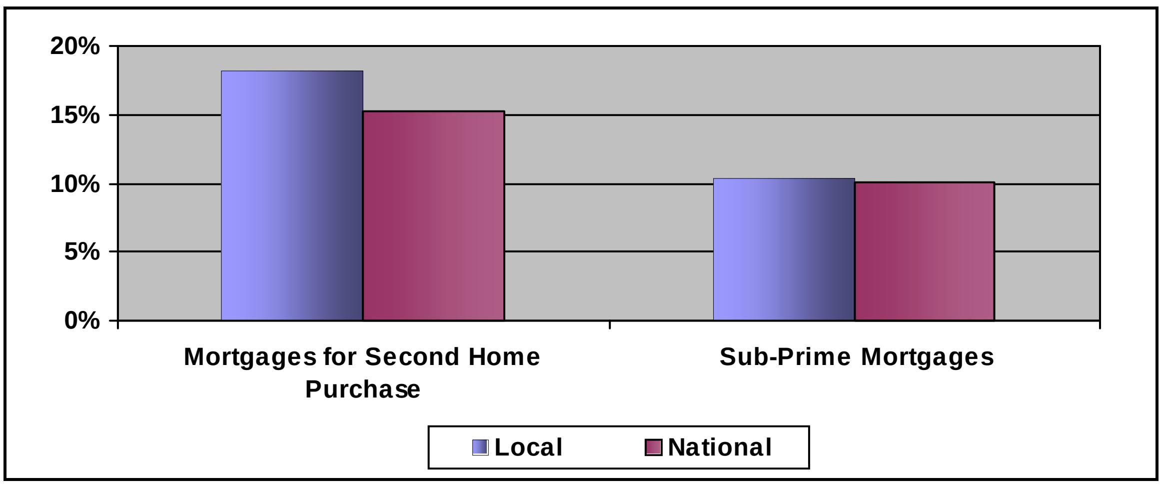
Ratio of 5-year Job Gains over 5-year New Single-family Home Construction



Mortgage Activity

- Mortgage lending in the region has expanded to second-home investors/speculators. The share of loans for non-owner-occupied properties was 18%, higher than the national average of 15%.
- Lending has expanded to less credit-worthy borrowers. The percentage of sub-prime loans (those carrying interest rates at least 3 percentage points higher than market rates) was 10%, and though that matches the national average, it exceeds the state average.
- 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 and California markets are likely to benefit as a result.

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 $13,800 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	$324,500
1985	$295,700
1990	$250,500
1995	$250,900
2000	$224,400
2001	$207,800
2002	$187,100
2003	$144,200
2004	$65,100
2005	($13,800)

- 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.

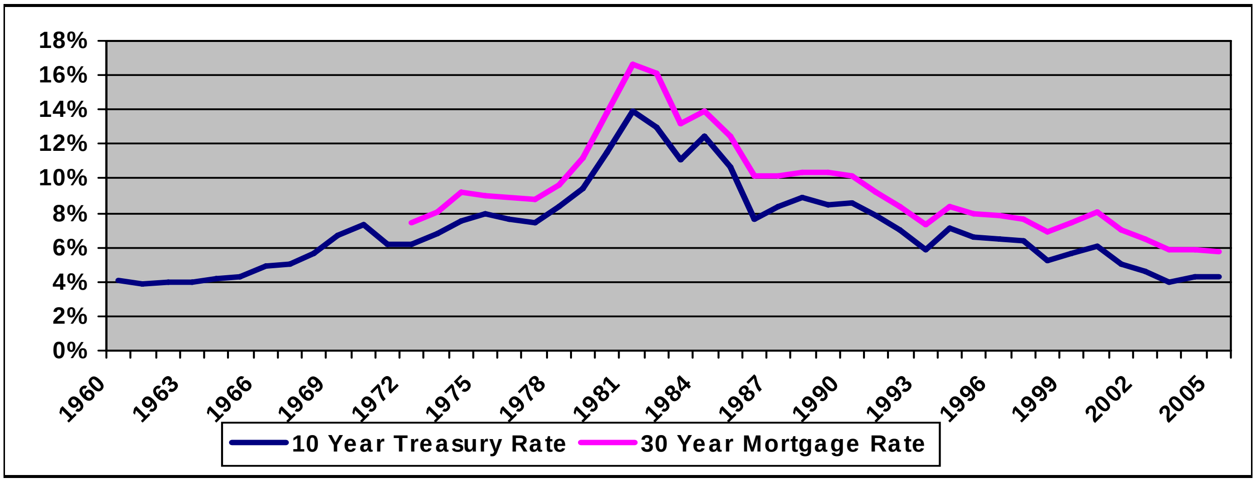
Housing Equity Gain				
Appreciation Rate	***1.5%***	***3.0%***	***4.5%***	***7.1%***
Conservative Scenarios	***Low***	***Middle***	***High***	*25-year average rate*
2010	$55,600	$86,200	$118,600	$178,700
2015	$120,400	$188,700	$266,600	$426,200
2020	$200,800	$315,500	$456,100	$774,000
2030	$424,900	$664,500	$1,004,300	$1,942,700
2040	$627,600	$1,048,700	$1,739,500	$4,078,000

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.

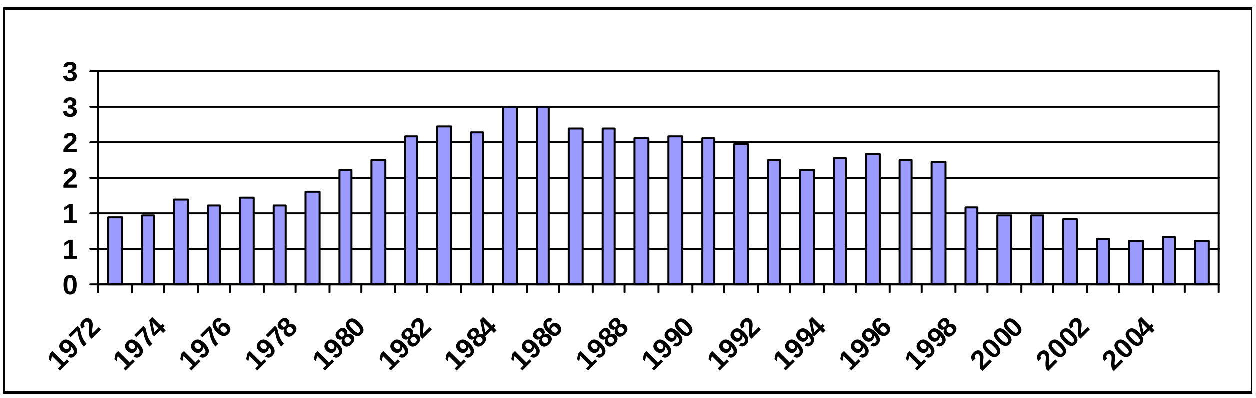
Additional Informative Charts

45-year Low Mortgage Rates



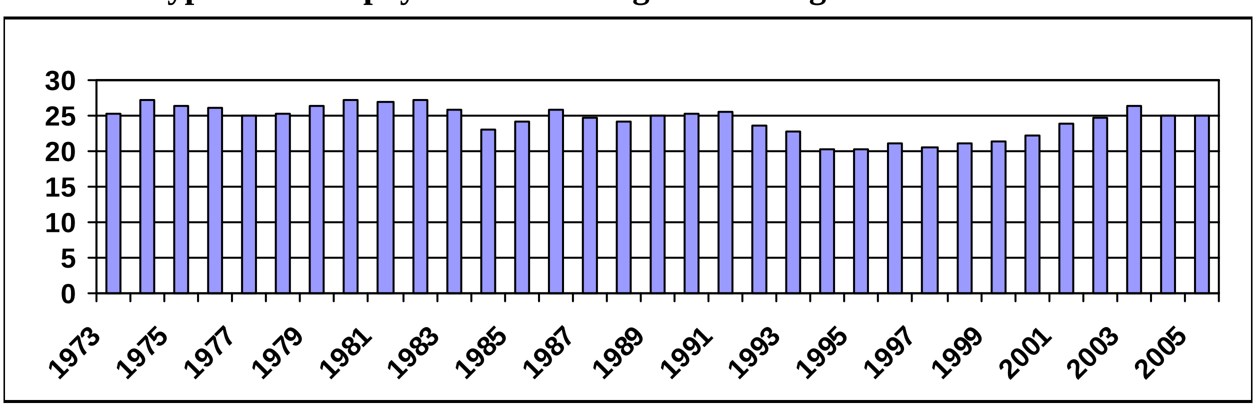
Source: Freddie Mac, Federal Reserve

Historic Low Fees and Points for Mortgage Origination



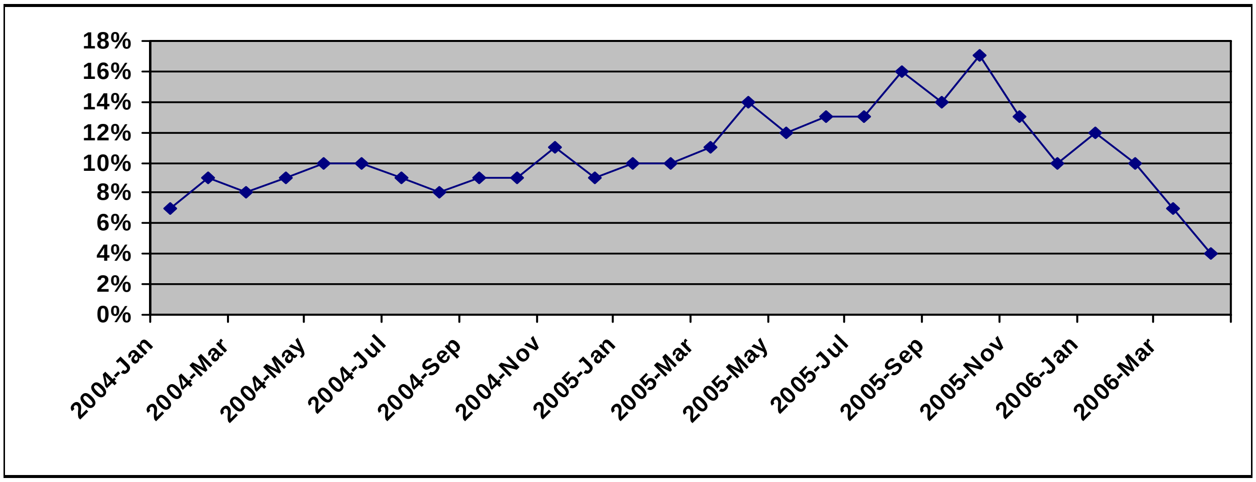
Source: Freddie Mac, Federal Reserve

Typical Down-payment Percentage Returning to Historic Norms



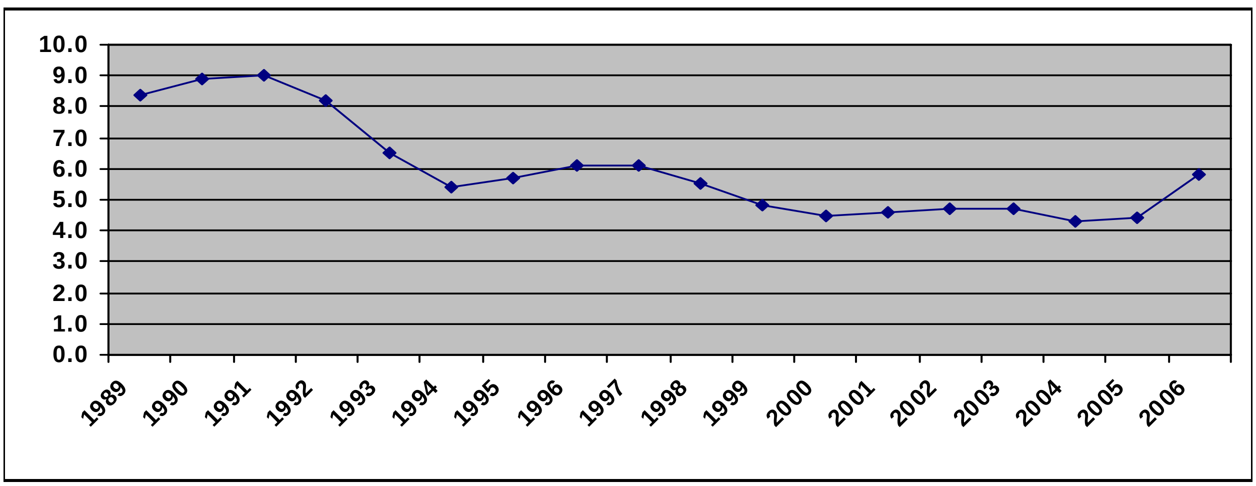
Source: Federal Housing Finance Board

Recent National Price Deceleration



Source: NAR

Historical National Months Supply of Homes on the Market



Source: NAR

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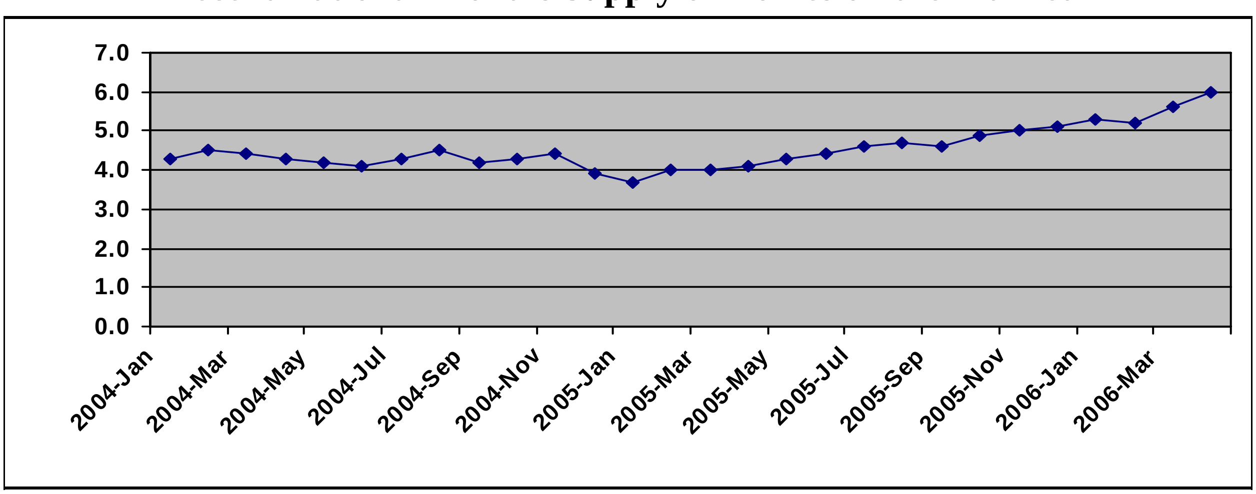

Source: NAR

NAR Research

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