

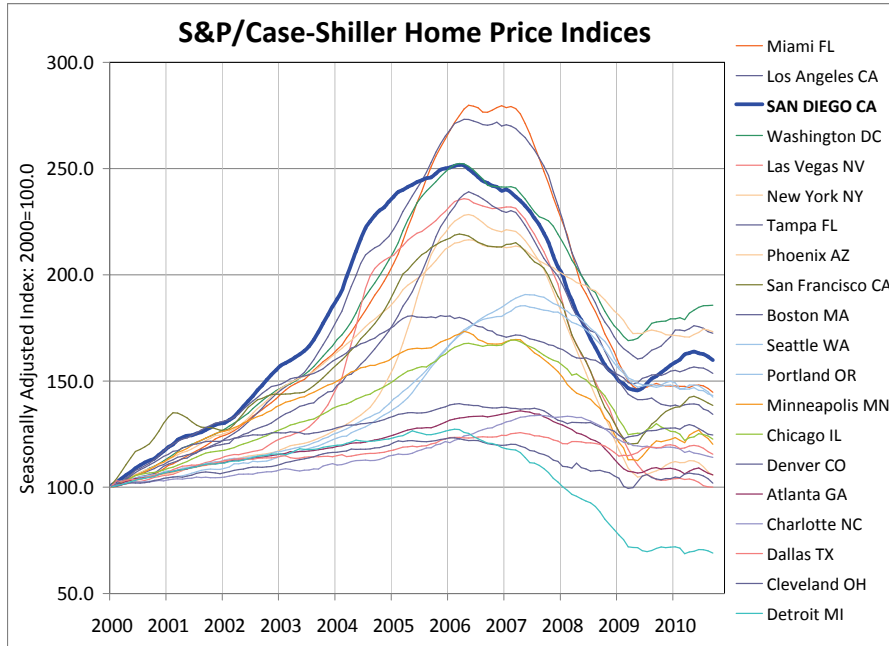


San Diego Housing Dynamics: A New Reality?

With the lowest mortgage interest rates of the past 60 years, and homes more affordable to buyers in nearly two decades, San Diego's housing market could be sizzling.

But the market continues to labor under heavy burdens of persistent high unemployment and tight credit, while glut of foreclosures weigh down values. After the home-buyer tax credit expired earlier in 2010, sales of homes weakened again. Legal squabbling over the process of repossessing homes caused sales of many foreclosed properties to be postponed striking another blow to already shaky confidence in the home-buying market.

The dynamics of San Diego's housing market suggest prices are not likely to return to previous highs anytime soon. **In fact at the current pace of increase - if continued - home prices are likely to stay below former**



peaks for another 8 to 10 years. Adjusted for inflation, prices may never reach previous highs without an unprecedented and unexpected rise of area household incomes.

Going up and coming down

Home prices in San Diego, along with the rest of the nation, largely erupted in the 2000s when interest rates were imprudently kept low and

credit was too easily extended. San Diego's chronically constrained supply of homes, especially with limited available affordable housing, exacerbated the extreme run up of values. Irregularly flexible credit standards extended to would-be home buyers allowed prices to rise to unprecedented and unsustainable levels.

The S&P Case-Shiller index of the nation's major housing markets reveals San Diego leading the historic price bubble. From 2002 to 2005 San Diego showed the highest increase of prices among the nation's 20 largest metro areas. As the increase started softening in 2005, Miami and Los Angeles soon overtook and exceeded San Diego.

During this time housing construction boomed in San Diego, recovering from the deep slump of the first half of the 1990s. Construction in the 2000s, however, never matched former building booms. The number of housing

units authorized for construction in the 2000s was less than half the numbers recorded in the 1970s and 1980s, despite San Diego's population more than doubling since that time. As the population expanded in the 2000s, comparatively fewer homes were built, and those that were built were much more expensive, particularly compared with household income levels.

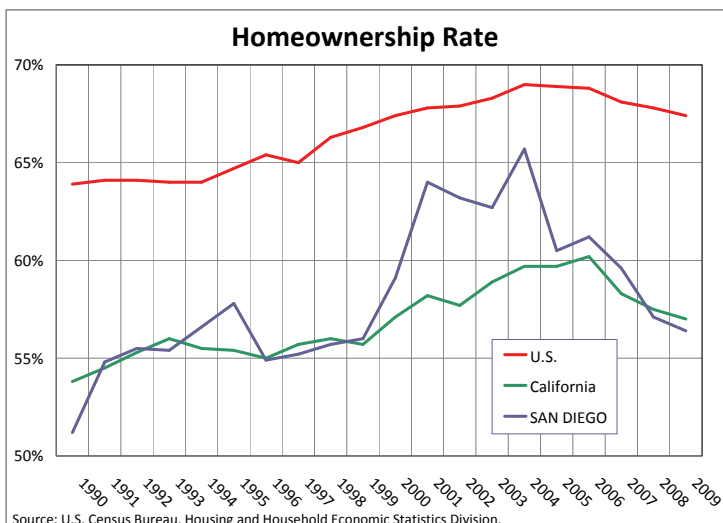
But what so often goes up, often comes down. San Diego also subsequently led the nation's inevitable price correction. By early 2006, San Diego was among the first areas to show home prices start collapsing. Over the next four years, prices had fallen 42.2 percent by May 2009. There was a bit of a comeback with prices rising 12.5 percent as of May 2010, but in the past 6 months faded again, slipping 2.4 percent as of the latest September 2010 report.¹

Prices are back to where they were in 2003. Adjusted for inflation, home values are where they were in 1999.

A lost decade, indeed!

Homeownership rises and falls

Along with the rest of California, San Diego has chronically lower homeownership rates than the rest of the nation. The reasons for this are multifaceted due to relatively high home prices, constrained supply, limitations on new construction, and property tax and fee imbalances. Constraints on supply, particularly in areas



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

(Continued on page 2)

proximate to fast growing employment centers, drives up prices and causes lengthier commutes. High property taxes and impact fees serve as barriers for first-time buyers and to home ownership, especially as lenders require substantial down payments before approving mortgages. The state's population also trends younger and is much more transient than many areas of the nation.

When the home price bubble started developing, homeownership rates in San Diego actually rose, quickly rising from just 56 percent in 1999 to historic high of 66 percent in 2003. This was also a period of aggressive efforts toward condo conversions, with thousands of apartment units restructured to sell as condominiums. Once prices reached the stratosphere in the mid 2000s, ownership rates quickly fell – largely because buyers could no longer afford such excessive prices.

Some San Diegans sold their homes during this time at considerable profit and downsized or moved out of the area. Others were caught when flexible mortgage rates and initial interest only payment schemes reset after introductory periods and they could no longer afford the higher monthly payments. Job losses and income reductions also aggravated the situation.

When the music stopped, prices started falling, credit grew tighter, foreclosures began to uptick, and ownership rates further declined.

Affordability rates improve but remain among the lowest in the nation

The latest National Association of Home Builders' (NAHB) "Housing

Opportunity Index", even with the unprecedented collapse of home prices, shows San Diego remains among the nation's least affordable housing markets. The index of affordability is determined by comparing metro area median family income against the price of homes sold during the period. San Diego's 51.1 percent share of homes sold affordable to median income was 12th lowest. California leads this dubious list with 8 of the nation's 12 least affordable housing markets.

San Diego's affordability rating by this measurement actually improved considerably. Between 2004 and 2006, only 3.6 to 7.0 percent of area households could afford the median price of homes sold. In the 1st quarter of 2004, San Diego had the "distinction" as the nation's least affordable housing market, but was soon overtaken by

Year	Qtr	Housing Oppor-tunity Index*	Natl Rank +	Median		Ratio of Home Price to Income
				Price	Family Income	
2004	1st	10.4	163	\$412,000	\$63,400	6.50
	2nd	8.7	158	440,000		7.00
	3rd	5.4	161	470,000		7.47
	4th	5.3	158	465,000		7.39
2005	1st	7.0	153	455,000	\$62,900	7.23
	2nd	5.1	153	474,000		7.54
	3rd	5.1	154	489,000		7.77
	4th	3.6	154	500,000		7.95
2006	1st	5.2	177	491,000	64,900	7.57
	2nd	4.6	194	490,000		7.55
	3rd	4.9	195	477,000		7.35
	4th	5.0	197	475,000		7.32
2007	1st	9.4	207	460,000	69,400	6.63
	2nd	9.6	203	470,000		6.77
	3rd	10.1	200	440,000		6.34
	4th	14.3	205	412,000		5.94
2008	1st	25.2	208	368,000	72,100	5.10
	2nd	31.1	203	342,000		4.74
	3rd	38.7	192	308,000		4.27
	4th	44.6	197	295,000		4.09
2009	1st	58.8	198	270,000	74,900	3.60
	2nd	56.0	203	285,000		3.81
	3rd	50.2	209	300,000		4.01
	4th	48.1	215	319,000		4.26
2010	1st	46.6	214	310,000	75,500	4.11
	2nd	44.0	216	321,000		4.25
	3rd	51.1	215	325,000		4.30

*Share of homes sold during the quarter affordable to median income
+Affordability ranking among 226 metropolitan areas.
Source: National Association of Home Builders; National University System Institute for Policy Research.

Los Angeles, Orange, and other California metro areas in subsequent quarters.

Despite the median price of homes sold decreasing 46 percent over the past four years, affordability remains a significant challenge. But other metro areas also saw home values declining. Thus when all is said and done, San Diego remains at about the same relative position where it has traditionally been for affordability ranking.

It is also important to note that two factors drive these results. San Diego home prices are traditionally high - 15th highest as of the 3rd quarter of 2010 among 226 metro areas measured by the NAHB. The region also has the 44th highest median household income. The combination of high home prices and relatively moderate household income results in the low affordability ranking.

Least Affordable Rank	Metro Area	Housing Oppor-tunity Index+	Median Home Sales Price	Median Family Income	Ratio of Home Price to Income
1	New York-White Plains-Wayne, NY-NJ*	22.6	\$435,000	\$65,600	6.63
2	<i>San Francisco-San Mateo-Redwood City, CA*</i>	28.0	<i>600,000</i>	<i>99,400</i>	<i>6.04</i>
3	Bridgeport-Stamford-Norwalk, CT	39.2	424,000	86,600	4.90
4	Santa Cruz-Watsonville, CA	40.1	441,000	84,200	5.24
5	Los Angeles-Long Beach-Glendale, CA*	40.3	320,000	63,000	5.08
6	Santa Ana-Anaheim-Irvine, CA*	41.5	426,000	87,200	4.89
7	Honolulu, HI	42.2	420,000	81,700	5.14
8	San Luis Obispo-Paso Robles, CA	42.9	351,000	72,500	4.84
9	San Jose-Sunnyvale-Santa Clara, CA	48.0	466,000	103,500	4.50
10	Santa Barbara-Santa Maria-Goleta, CA	50.6	319,000	71,400	4.47
11	Newark-Union, NJ-PA*	50.7	335,000	88,800	3.77
12	SAN DIEGO-CARLSBAD-SAN MARCOS, CA	51.1	325,000	75,500	4.30
13	Ocean City, NJ	51.4	275,000	68,100	4.04
14	Napa, CA	52.8	350,000	81,800	4.28
15	Nassau-Suffolk, NY*	53.8	380,000	103,600	3.67
16	Laredo, TX	55.6	122,000	38,000	3.21
17	Brownsville-Harlingen, TX	55.8	107,000	33,500	3.19
18	Mc Allen-Edinburg-Mission, TX	55.8	102,000	33,200	3.07
19	Oxnard-Thousand Oaks-Ventura, CA	55.9	355,000	86,700	4.09
20	El Paso, TX	57.2	134,000	40,900	3.28
21	Santa Rosa-Petaluma, CA	57.3	320,000	80,400	3.98
22	Cambridge-Newton-Framingham, MA*	57.4	364,000	98,700	3.69
23	Barnstable Town, MA	59.8	270,000	75,300	3.59
24	Santa Fe, NM	59.8	263,000	66,900	3.93
25	Boston-Quincy, MA*	60.5	307,000	85,200	3.60

*Indicates Metropolitan Divisions, all others are Metropolitan Statistical Areas. *California areas are in italics.*
+Share of homes sold during the quarter affordable to median income.
Source: National Association of Home Builders; National University System Institute for Policy Research.

Housing price and household income imbalances

The comparison of local median home prices to median household incomes reveals how out-of-balance the housing market had gotten. The ratio to San Diego's median home price reached well above 7.0 times the median household income between 2004 and 2006, clearly unsustainable for local market demand. The ratio subsequently collapsed to less than 4.0 times median income, still high by nationwide standards, but relatively good for coastal California. The ratio has climbed upwards again in 2010 ranging between 4.1 and 4.3.

The same comparison for other major California metro areas shows even higher imbalances. The inland Riverside-San Bernardino metro area is the exception where a much lower price to income comparison indicates far better affordability.

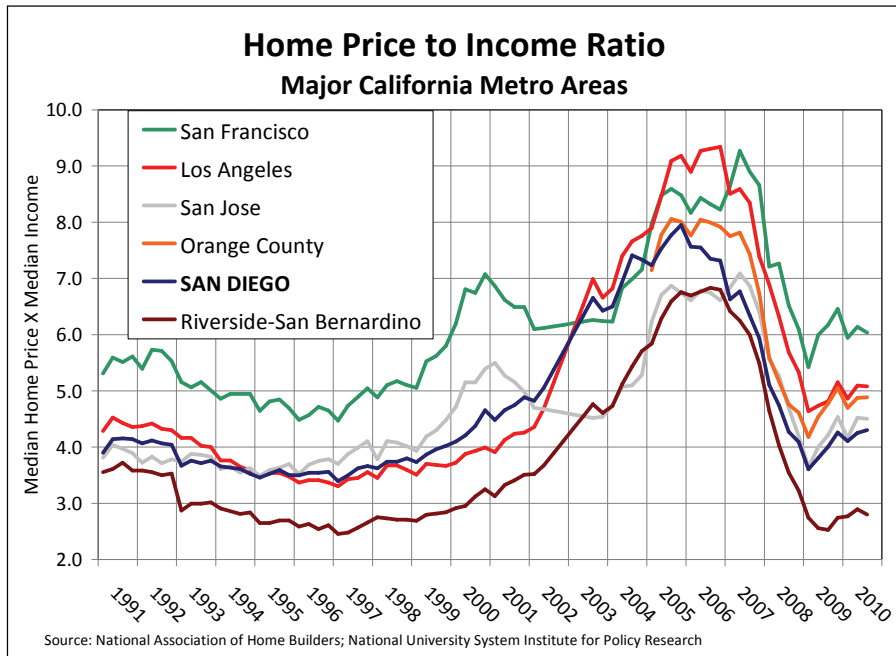
Imbalance of population, jobs, incomes, housing supply and prices

The following chart illustrates the dynamics of San Diego's housing market over the past two decades. Between 1990 and 2000 housing prices were generally in line with the supply of homes, population gains, job growth and income. As these factors rose (and given a relatively inelastic housing market in communities near job centers), housing prices adjusted for inflation rose only 20 percent over the decade.

By 2001 housing prices started to "decouple" from this relationship. Whereas jobs, population, income and supply plodded along in lockstep gradually upward, homes prices went on an unprecedented ride. More than any other chart in this report, this dramatically illustrates the disconnect of the housing bubble that inflated and subsequently collapsed over the first decade of the 21st century.

The collateral damage from the bubble collapse

With home sales and prices collapsing, and foreclosures rising, residential construction activity throughout the region also collapsed. The number of housing units authorized for construction across the County fell to only 2,946 in 2009, the lowest annual number recorded in San Diego since before pre-World War II, and despite the population



increasing more than 10 times (1009 percent) over this 80-year period. The number approved in 2010 started at a higher pace before slipping in more recent months. By the end of the year, only 3,500 will be issued, the second lowest year on record.

Housing prices began faltering in San Diego well before job losses and unemployment started escalating. The collapse of home values soon aggravated additional job losses as a large portion of the economy derives from building, selling, and leasing real estate. The San Diego metro area has one of the highest real estate

and construction proportions for a regional economy. (See *San Diego Economic Ledger* "October 2009 - Metropolitan GDP", page 5, www.nusinstitute.org)

Losses from building and selling real estate hampers many other sectors of the local economy. The losses of income and spending led to retail, services, and even manufacturing, investment, and government sectors being hit by the collateral damage.

The outlook for housing from here

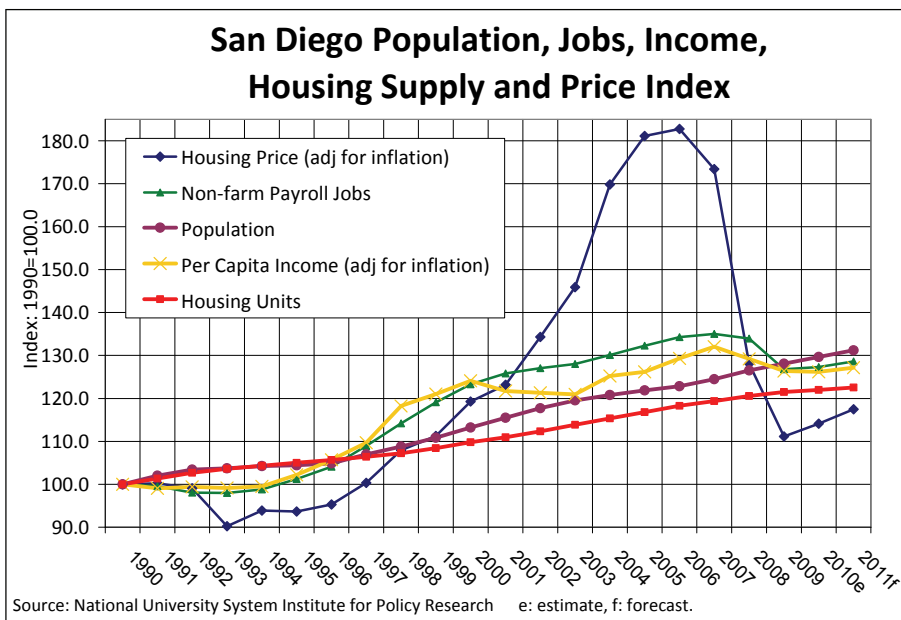
Our forecast for 2011 is that housing prices will continue to

slightly improve, in large part because prices dropped so low and are much more affordable to household income earnings. Sharp increases in prices or number of sales transactions, however, are not anticipated. Indeed, we believe it will be several years before housing comes back into equilibrium to the region's population, job, and income growth.

While recent stabilizing home prices suggest the beginnings of improvement, there are still headwinds. A large number of foreclosed

and repossessed homes held by financial institutions remain and still need to be marketed and resold by lenders. The assets are only held back to keep prices somewhat stable. According to an article in *Mortgage Match News*, "Lenders are holding back foreclosed homes to prevent a glut from further depressing prices and eroding the value of bank-owned properties. 'The conventional view is if you have 10 foreclosed properties in an area you don't want to put all 10 houses on the market,' explains Dean Baker, co-director of the *Center for Economic and Policy Research*." Such dynamics also put deflationary pressures on the market, as buyers anticipating or fearing additional distressed sales and further prices drops postpone buying. While interest rates remain at historic lows, more stringent loan standards and processing waits make home-buying difficult. A significant amount of housing stock also remains unaffordable for a major portion of would-be buyers.

For those waiting or anticipating San Diego's housing market to quickly rebound



to former highs, the ratio of price constrained by area incomes suggests this will not be happening soon. It is difficult to conceive of similar financial conditions allowing such high imbalances to area incomes redeveloping. While certain areas of the local housing market may see rapid price hikes again, particularly in upscale and constrained areas along the coast or other premium locales, those markets are not dependent upon working-level household incomes. Median and lower household incomes limit how much home prices overall will rise. Those anticipating prices returning to former peaks of the mid-2000s will be waiting a long time.

In the mid-term we see other troubling signs. The depressed level of new housing construction and especially the loss of firms with experience and know-how to entitle properties and navigate through San Diego's restrictive building codes are likely to lead to a delayed response once increased demand reemerges. While the glut of foreclosures and weak demand for housing is keeping prices subdued for the time being, in the midterm rapid price corrections could eventually develop and, we fear, the kind of price signals that helped create the irrational exuberance of the past decade might reappear. We are hoping for greater sobriety and more careful consideration of market

Dashboard Observations—October 2010

By Kelly Cunningham, Economist, Senior Fellow

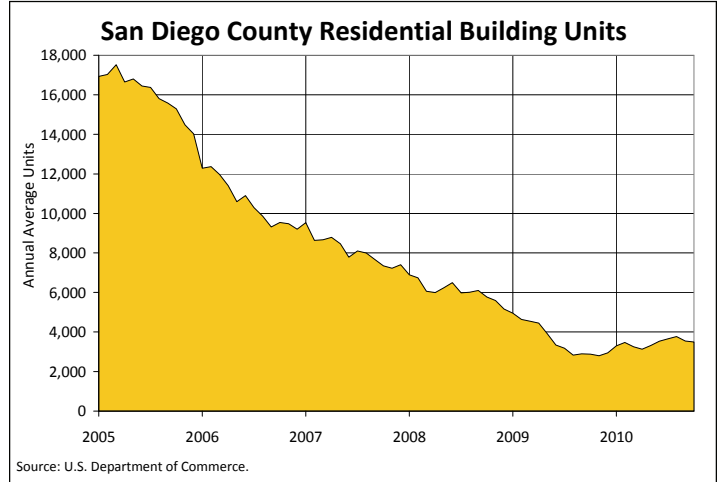
All “Dashboard” indicators were positive in the month of October 2010 except residential building. The number of housing units authorized for construction in 2010 is showing increases over 2009's 80-year low number, despite faltering the two most recent months. As of October 2010, the number of units under construction are running 21.6 percent above the previous year, but will still end the year as the second lowest on record in San Diego since World War II.

San Diego's unemployment rate was 10.3 percent in October 2010, more than 2 percentage points lower than the rest of California at 12.4, but 0.7 percent higher than the rest of the nation at 9.6 percent. The seasonal adjustment shows the rate improving over September's rate.

The City of San Diego certified 1,111 new businesses licenses in October, a strong jump from the previous month and from a year ago. Despite the latest gain, the numbers issued so far in 2010 is running 7.6 percent lower than the period in 2009, and is the lowest amount since 2002.

fundamental this time around.

¹“Broad-based Declines in Home Prices in the 3rd Quarter of 2010”,



Indicator	Oct 2010	Month Change (Sea. Adj.)	Annual Change
Unemployment Rate¹ San Diego County	10.3%	-0.3% ▲	-0.3% ▲
Residential Building² Units authorized for construction San Diego County	145	-15.9% ▼	-24.9% ▼
New Business Licenses³ Issued by City of San Diego	1,111	35.0% ▲	4.9% ▲
San Diego Stock Index⁴ San Diego based companies 2nd Thursday of month	114.0	5.5% ▲	2.4% ▲

¹California Employment Development Department.

²U.S. Bureau of the Census.

³Business Tax Program, City of San Diego.

⁴Second Thursday of month, Bloomberg News, San Diego Daily Transcript.

The stock index of San Diego based companies continues to rebound since the end of 2008 and early 2009. In spite of

significant volatility, the October index of 114.0 represents rising values for major San Diego corporations.

S&P/Case-Shiller Home Price Indices, November 30, 2010, www.standardandpoors.com.

²Emmet Pierce, “Shadow Inventory

on the Rise,” *Mortgage Match News*, December 2, 2010, <http://www.mortgagematch.com/news/home-buying-and-selling/shadow-inventory-on-the-rise-324/>.



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