2011 Residential Outlook

Virtuous or Vicious?

By Robert Freedman

The elements needed for a housing recovery are lining up, but business spending and consumer confidence must cooperate.

It's slow. It's uneven. But it's there: the home sales recovery.

"There will be two steps forward, one step back, with sizable local market differences," says NATIONAL ASSOCIATION OF REALTORS® Chief Economist Lawrence Yun, "but the trend nevertheless will be a rise in home sale activity in the upcoming years."

Yun is forecasting 5.2 million existing-home sales in 2011, up from 4.8 million last year. He also expects modest improvement in prices—a rise of about 1 percent this year on a national basis. That would be the first in what Yun says will be a series of small but steady gains in the years ahead that will eventually bring home sales back to a period of normalcy.

At the root of these gains is continuing improvement in the overall economy. Yun is estimating modest 2.5 percent growth in the country's gross domestic product in each of the next two years, job gains of about 1.5 million in the same time frame, and a slowly improving jobless rate, which he projects will dip from a stubbornly high 9.6 percent in the latter part of 2010 to a better but still-high 8 percent in 2012.

This is what Yun calls the "virtuous cycle" that residential real estate started entering a few months after the home buyer tax credit ended in the middle of 2010. At that time, home sales took a big hit, dropping 27 percent in July. But in August, sales picked up again, under their own steam, and have been gaining ever since without the aid of subsidy.

Will Businesses Pony Up?

Whether this virtuous cycle continues into 2011 or spins into a vicious cycle of stagnant sales and falling prices depends first and foremost on business spending. "This is the big difference between this economic recovery and those in the past," Yun says.

In the past, as the economy emerged from recession, businesses poured money into growing their capacity—hiring workers, renting office space, replacing old equipment—to position themselves for growth. But that hasn't happened this time.

The reluctance among business leaders to spend, despite sitting on money from strong profit growth during the recovery, stems from low consumer confidence.

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	2009	2010	2011*
ECONOMIC INDICATORS			
U.S. gross domestic product	-2.6%	2.7%	2.4%
U.S. Consumer Price Index	-0.3%	1.6%	1.8%
U.S. unemployment rate	9.3%	9.7%	9.5%
HOUSING			
Existing-home sales			
Total sales (in millions)	$5.2	$4.8	$5.2
Median price	$172,500	$172,900	$173,800
Change in price	-12.9%	0.2%	0.5%
New-home sales			
Total sales	376,000	325,000	420,000
Median price	$215,900	$215,000	$220,200
Change in price	-7.0%	0.4%	2.4%
Affordability index	172	172	160
INVENTORY			
Housing starts	554,000	617,000	769,000
Months' supply (national average)	8.8%	9.5%†	NA
MORTGAGE FINANCING			
Federal funds rate	0.2%	0.1%	0.5%
30-year fixed rate	5.1%	4.7%	5.0%
One-year adjustable rate	4.7%	3.9%	4.1%

Commercial Markets (See page 17)

Source: NAR Research

* Projected

>>> With unemployment high and lingering concerns about whether home prices have really stabilized, consumers remain far from certain that the worst is behind them. The key confidence index that tracks their sentiment, the Conference Board's Consumer Confidence Index, remains far below what business leaders want to see before they start investing again. "Consumers think things are rotten in the country," Yun says.

Weak business spending also stems from uncertainty over how much it will cost to comply with last year's Wall Street and health care reform laws. Within the thousands of pages of new legislation are rules that have yet to be written, says Yun. "Businesses don't know fully what the rules of the game are going to be down the line."

But this reluctance isn't expected to last much longer. Yun and other analysts say business cash reserves have grown to the point where corporate leaders have to start deploying their money to get the kinds of returns their investors want to see. As Hugh Kelly of the New York University Schack Institute of Real Estate told REALTORS® in early November when he spoke at the 2010 Conference & Expo in New Orleans, "Investors want to get back into riskier investments."

What's Going on in Your Market?

Real estate practitioners from around the country chime in on what they're seeing in their geographic area and business niche.

Chetek, Wis. "We've had more closings in the last six months than we had in all of 2008 and 2009. What's helping us is that the Minneapolis market is coming back. That's our main source of business for second homes. As long as people feel more confident in the economy—and they are feeling more confident—they're looking to venture out into second homes. There's a lot of cash; one out of three buyers pays cash today."
G.C. ("Butch") Flor, GRI, SRES, Six Lakes Realty

Jacksonville, N.C. "Our market is going to stay fairly stable in 2011 and could even enter a little growth mode. Camp Lejeune, the big Marine base, has provided us with a very stable economy. The new-home market and the first-time market have been strong. The upper-end market has been a little slower because people coming from other parts of the country probably haven't been able to sell their houses. There's also been a lot of commercial development going on to support the military base."
Sheila Pierce, CCIM, Commercial Brokers Unlimited

Marietta, Ga. "Our market is slightly better this year at this time [November 2010] than it was a year ago. We have an overhang of distressed properties that's been a real damper on the market. If we get this overhang handled, we're going to see more improvement. There has to be some pent-up demand that's built up during this lull period." *Paul Brower, ABR, GRI, Harry Norman, REALTORS®*

South Lake Tahoe, Calif. "Sales are actually increasing now and have been for the past nine months. We're about 25 percent up from last year, and we're about six to nine months into stable pricing. A lot of the fence-sitters who were waiting to see what the market was going to do are now coming into the market. Their caution is paying off, because houses are so much more affordable and interest rates are great."
Debra Howard, CRS, RSPS, D. Howard & Co.

Low Prices Will Spur Recovery

Once businesses do pick up spending, job gains will quicken and home sales—fueled by strong affordability and plenty of pent-up demand—will rise.

Yun says all of the price excesses from the housing bubble have been squeezed out of the market and interest rates remain at historically low levels, making buying attractive now. In San Diego, for example, buyers at the end of 2010 would be paying $1,564 a month in mortgage payments for a median-priced house that at the height of the boom would have cost them $2,833 a month.

At the national level, the median home price at the end of 2010 was about $172,000, down roughly 30 percent from its $239,000 peak in early 2006 and, for the first time in a decade, less than its replacement cost.

"Home prices have overcorrected a bit," Yun says. "The cost of duplicating an existing home, when you factor in the expense of buying bricks and mortar and putting it all together, is going to be more expensive."

One reason that replacement costs are up is the large number of foreclosures that have to be worked through the market before existing-home prices can start to rise in any significant way. Yun expects foreclosed homes to account for a third of sales well into 2011, about the same as in 2010. "My best guess is that this year, people will be buying a lot of the foreclosed properties, but it will still take an additional one-and-a-half years to bring the inventory down to a more normal level."

Another sign that excesses have been removed from the housing market: an attractive ratio of home prices to income levels. The cost of homes peaked at almost 3.5 times their annual income during the boom. That ratio now stands at 2.4 times income, just below the more historically normal level of about 2.5.

In addition, the number of home sales compared with the size of the workforce peaked in 2005 (one home sale for every 20 employed persons). Now the ratio stands at just below 4:1 (one home sale for every 25 employed persons), in line with historical norms.

The Threat of Inflation

One of the big remaining questions is whether inflation, long dormant, is poised to return in 2011 or 2012 as the recovery solidifies and businesses start to raise prices.

At the end of 2010, inflation remained a nonissue, with the Consumer Price Index up a low 1.1 percent from 2009. Indeed, some analysts have even been talking about the risks of entering a period of Japanese-style deflation in which the expectation for continuing price drops keeps people from spending.

But there are signs that prices could start heading up soon, a possibility that the Federal Reserve fueled in late 2010 when it announced it would flood the economy with money by buying $600 billion worth of Treasury bonds in the first three quarters of 2011 to stimulate growth.

Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, said at the recent REALTORS® Conference in New Orleans, that keeping rates low might help the recovery in the short term, but the long-term consequences could be higher inflation that's difficult to manage. "We risk repeating past errors," he said.

Yun says inflation was quiescent in late 2010 mainly because of low housing rent growth. When you look at producer prices, though, which in late 2010 were up 4 percent for finished products and more than 20 percent for early-stage products and commodities, the picture looks very different. These increases are likely to show up in consumer prices soon, and they will be hard to reverse. "High inflation is like toothpaste," says Yun. "Once it's out of the tube, it's hard to put back in."

The impact will fall hardest on first-time buyers; as interest rates rise along with inflation, home ownership will become increasingly out of reach.

"Some inflation isn't a bad thing, but high inflation isn't optimal," Yun says. "So as long as inflation can be kept in check—and business and consumer confidence restored—look for a slow return to normalcy in the months ahead." ■

What's Going on in Related Industries?

Professionals who work in affiliated industries tell us where they see the market heading.

The Home Builder:
"Financing will loosen, but small builders will still have a tough time."

New-home sales will pick up and financing to home builders for developing new projects will loosen, although for smaller builders without a strong track record of obtaining financing, it will continue to be hard, says Dave Erickson, president of Gray Hawk Homes Inc., in Columbus, Ga. "For the average, day-to-day builder, it'll probably get better in the sense that banks will start talking to them, not that they'll start lending to them." Construction costs, particularly labor, have dropped over the last two years and will remain down for the first half of the year, but prices will head up in the second half. The costs of commodities such as concrete, copper, and Sheetrock are expected to rise, eventually leading to upward pressure on home prices or downward pressure on home sizes.

The Stager:
"Sellers want their house staged because they saw it on TV."

Activity in the staging industry has been growing "bit by bit" during the downturn as listing agents look for an edge in the bad economy and as banks show an increasing interest in staging to boost the selling price of REOs, says Barb Schwarz, CEO of Stagedhomes.com in Seattle. Also playing a role: Sellers' exposure to staging in the popular media. "Sellers are coming to agents and saying, 'We want this house staged because we saw on TV that homes sell faster and for more money when they're staged.'" The number of training classes hosted by her company remains the same as it was in the boom: between 80 and 120 a year. But attendance is down. "Instead of 90 students, we might see 50." Staging fees are also down, from a national average of about $2,800 to about $1,800, as sellers take more moderate approaches to staging their home, especially since they're often strapped for money.

The Home Inspector:
"Presale inspections are on the rise."

The improved housing market in 2011 will increase "transaction-based" inspections, which are the standard inspections ordered by buyers before finalizing their purchase, says Bill Redfern, CEO of A Buyer's Choice Home Inspections in Milwaukee. Those took a big hit during the downturn. But the industry could see business coming back even stronger than before the downturn because of the way inspectors have branched out into other types of activities when business was slow. Sellers, and particularly banks, have become far more interested than in the past in having presale inspections conducted to help attract buyers. This business, which helped sustain inspectors during the downturn, is expected to grow in 2011 even as regular inspections come back. "I might be optimistic, but I think in five to 10 years every listing coming to market will have a presale inspection done." Banks, entering into volume agreements with inspectors to get a handle on the extent of neglect or vandalism to a property before they put it on the market, are driving this new business. "Banks are seeing it as wise money spent to have a better idea in forecasting what they're ultimately going to get out of the property at sale or even if it's truly salable."