Orange County Housing Report: Happy New Year – A 2016 Forecast

January 3, 2016

Good Afternoon!

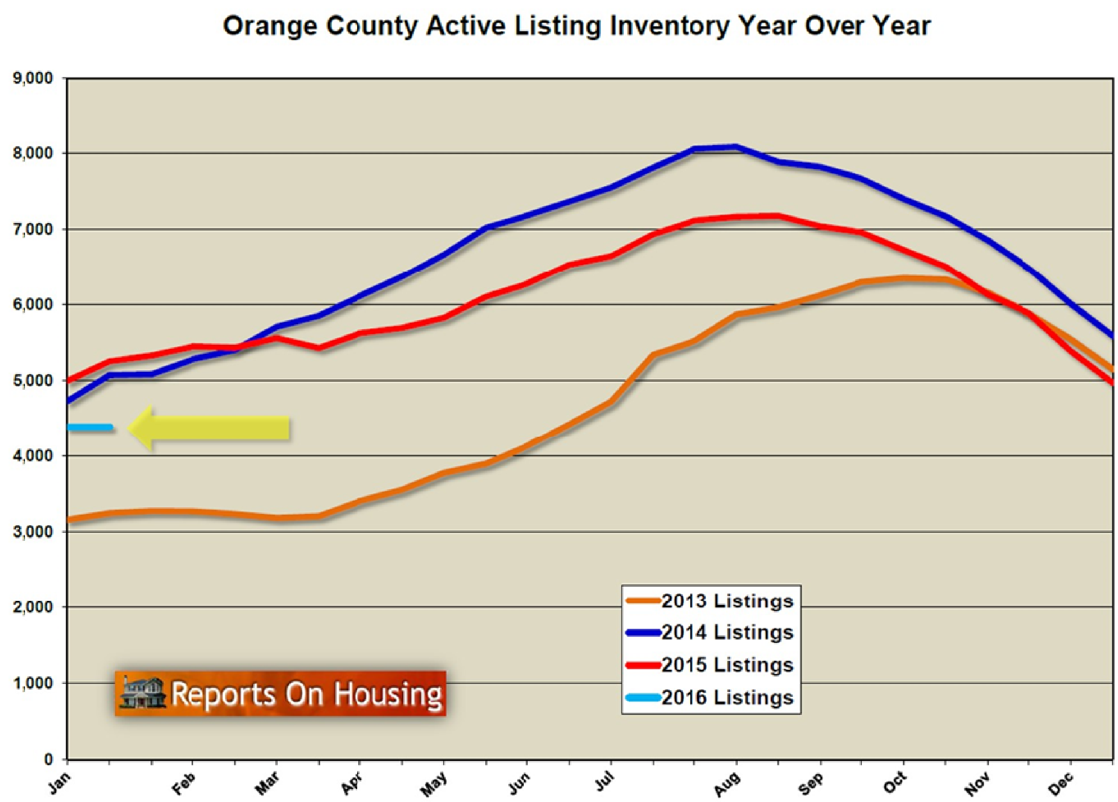
HAPPY NEW YEAR!!! Now, what does that mean for Orange County real estate?

First, let's take a look back at what happened in 2015 in terms of the inventory, demand, expected market time, and distressed properties.

Active Inventory: *Since demand was stronger in 2015, the inventory did not grow as much.*
The year started and ended with an active inventory of 5,000 homes on the market. In spite of the fact that sellers were inclined to initially overprice their homes, sellers found a lot more success in 2015 compared to 2014. There were only 888 more homes placed on the market in 2015, yet there were 2,457 more sales, 8.7% more than the prior year.

In January, it looked like the year was going to be a mirror image of 2014. The inventory methodically grew in 2014 on the backs of overpriced, overzealous sellers, finally reaching a peak of nearly 8,100 homes. Yet, by mid-February 2015, the market shifted gears and demand took off. It was noticeably stronger than 2014, but it was not as sizzling hot as 2012 and 2013. Back then, sellers were able to get away with aggressively stretching their price and the Orange County housing market appreciated at a fairly rapid rate. The market was hotter in 2015 compared to 2014, but if a seller stretched the price too much, the home would not sell. Overzealous sellers had to adjust their asking price in order to find success.

The first half of the year was strong and homes appreciated nearly 5% by the end of June. Once the summer months took hold though, the market shifted. Many homeowners mistakenly believe that the Summer Market is the best time of the year to place a home on the market. That's simply not true. There are plenty of closed sales during the summer months, a great time to move a family, but the majority of those sales are put together and placed into escrow during the Spring Market. The spring is the optimum time to list a home for sale. By the time summer roles along, demand starts to drop and the inventory rises until it peaks in August. The peak in 2015 occurred in mid-August at nearly 7,200 homes, 900 fewer than 2014. As demand began to drop, buyers focused on paying close to the **Fair Market Value** for a home and were reluctant to pay much more than the most recent sale.



During the Autumn Market, from September through Thanksgiving, fewer homeowners placed their homes on the market, part of a normal housing cycle. Since the Spring and Summer Markets were in the rearview mirror, many sellers opted to throw in the towel and pull their homes off of the market. Consequently, the active inventory dropped unabated through the end of the year. The active inventory shed 2,195 homes, or 31%. For the most part, seller understood that they either reduced their asking price closer to their **Fair Market Values** or it was time to throw in the proverbial towel.

Within the past two weeks, the inventory shed an additional 576 homes, a 12% drop, and now totals 4,396. Last year at this time there were 604 more homes on the market. The current level of homes on the active listing market is extremely anemic. Over the past eleven years, only 2013 had fewer homes to start a New Year with 3,161. Price appreciation has everything to do with supply and demand. With such a low supply, 2016 is definitely starting on the right foot.

<u>Demand</u>: *This year it was all about cashing in and purchasing a home prior to the Fed making a move on interest rates.* The housing market in Orange County typically revs its engine right after the Super Bowl with a spike in demand (the number of new pending sales over the prior month). 2015 was no different and even outpaced the surge in 2014. Demand during the Spring Market was about 15% stronger than the year prior, 11% stronger during the Summer Market, and 8% stronger during the Autumn Market. Demand peaked in May at 3,138 pending sales, up 11% compared to the peak in 2014.

In 2015, buyers were taking advantage of historically low rates prior to the Federal Reserve raising the short term interest rate for the first time in nearly a decade. The Federal Reserve kept stalling the initial rise in rates. Expectation of a rate hike moved from the spring to the fall to the very end of the year. They finally did pull the trigger on an increase, but that did not come until mid-December. The initial rate increase was more symbolic than anything else. It meant that the Federal Reserve was in control of the monetary system once again.

Interest rates remained cheap, at about 4.25% by year's end, even with the Fed making a move. Placed in proper perspective, it was no wonder buyers were lining up to purchase. In 1990, the interest rate was 10%. In 2000, it was 8%. And, just prior to the Great Recession, interest rates were at 6.4%. With all of the hype surrounding the beginning to the end of historically low interest rates, demand surged.

During the first half of the year, many buyers were unsuccessful after writing a couple of offers to purchase. This explains why they were willing to stretch a little and pay more than the most recent comparable sale. As demand slowed during the second half, they weren't as willing to stretch as much, desiring instead to pay close to a home's **Fair Market Value**.

Within the past two weeks, demand dropped by 326 pending sales, or 17%, and now sits at 1,629. Compared to one year ago, current demand is up 10% with 151 additional pending sales.

<u>Distressed Properties</u>: *Foreclosures and short sales played a very tiny role in the Orange County housing market.* In Orange County, homes have appreciated substantially since the beginning of 2012. Fewer homes are underwater, about 2.5% of all mortgage homes compared to 25% during the Great Recession. Distressed sales are now just an asterisk in the overall housing market, insignificant and almost not worth mentioning in reviewing 2015.

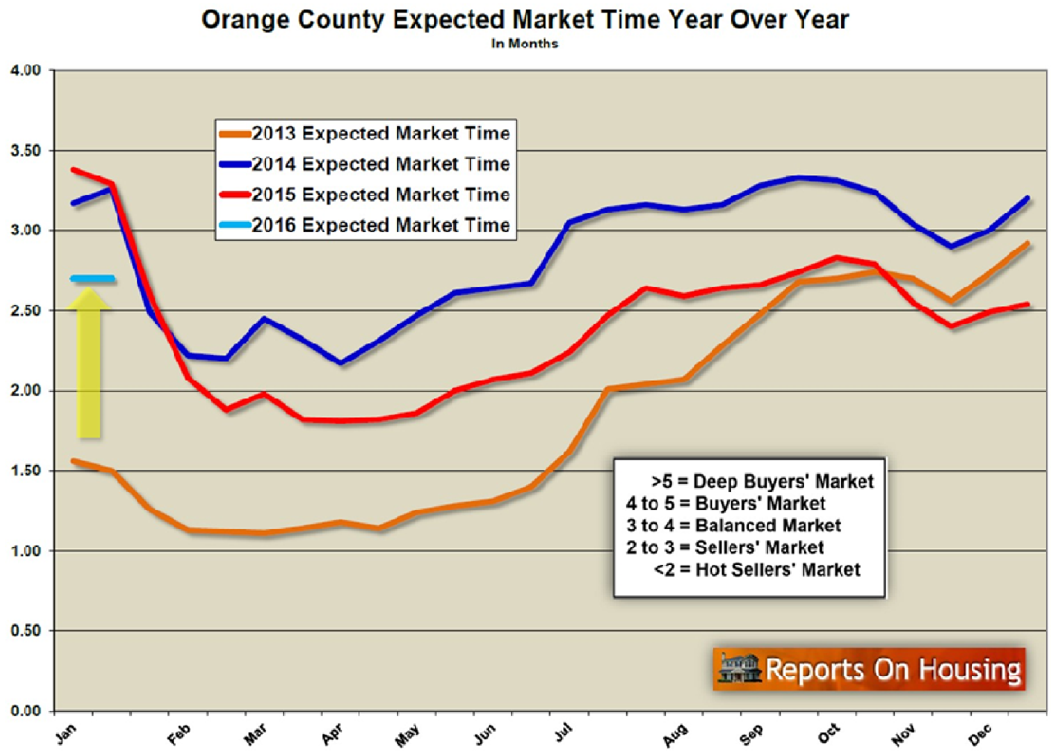
Back in 2012, distressed homes accounted for 36% of closed sales. In 2015, it only accounted for 5%. But, not much has changed since 2014 when 5.5% of closed sales were distressed. The market has continued to work its way through a similar number of distressed homes for the past two years, and the trend is more of the same.

The distressed inventory started the year at 262 total foreclosures and short sales, and ended the year at 182, a difference of 81, or 43% fewer. 1.5% of all closed sales in 2015 were foreclosures and 2.6% were short sales.

<u>Expected Market Time</u>: *It was a seller's market all year long with the exception of January.* In January 2015, the market did not favor a buyer or seller. The expected market time (the length of time it would take to sell a home based upon current supply and demand) dipped to the seller's favor as demand increased dramatically and the active listing inventory only grew slightly. From February through May, the expected market time dropped below the 60-day mark, a level where homes appreciate at a faster clip. The expected market time slowed a bit during the Summer Market, and from July through the end of the year, it was only a slight seller's market, meaning that housing was only slowly appreciating, yet sellers get to control more of the terms of a sale during the negotiating process.

The expected market time for all of Orange County grew to 81 days in the past two weeks, but is still a great start to a New Year. As a matter of fact, in the past 11 years, this year is the second best start. The best start to a year occurred in 2013 with an expected market time of 47 days.

For homes priced below $1 million, the expected market time is 60 days. For homes over $1 million, the expected market time rises to 7.9 months.



<u>The 2016 Forecast</u>: *It may be a carbon copy of 2015, it all depends upon the Federal Reserve.*
The Federal Reserve has finally established that they are now ready to end the era of rock bottom, historically low interest rates with a quarter percent hike in the short term rate in mid-December. This marked the first increase in over nine years. They also hinted at more increases in 2016, as many as three or four. It is important to note that long term mortgage rates are not immediately impacted by changes in the short term rate, but multiple increases will definitely have an impact on the Orange County housing market. Here's the forecast:

- **Interest Rates** – mortgage rates have remained at historically low levels due to the Federal Reserve's manipulation of the monetary system, keeping the Federal Funds Rate at zero for over seven years. Yet, that changed last month with their first rate hike in nine years. The Federal Reserve meets eight times per year and it will most likely pull the trigger on further increases three more times in 2016: the first one probably in June, the second in September, and then the third in December. Thus, long term rates will be slow to move up and buyers will be able to cash in on interest rates in the low fours throughout the Spring Market. By year's end, expect interest rates to eclipse 4.75%.
- **Active Inventory** – due to strong demand in the Spring Market, the inventory will remain at anemic levels and will not begin to really rise by much until the Summer Market. Expect the inventory to peak in August between 7,500 to 8,000 homes, well below the long term average of 8,500 homes.
- **Demand** – with an anemic inventory and buyers anxious to cash in on historically low rates before they rise, demand will be strong during the Spring Market. Buyers will be willing to stretch a bit in price over the most recent sale; so, expect appreciation around 4% during the first 6-months of the year. As the Fed increases rates, buyers for the second half of the year will not want to pay too much. They will be looking to pay close to a home's **Fair Market Value**. Demand will fall slowly and appreciation will be flat for the second half of the year.
- **Housing Cycle** - the housing market will follow a normal housing cycle. The strongest demand coupled with a lot of fresh inventory will occur during the Spring Market, followed by slightly less demand and a continued fresh supply of homes in the Summer Market, then another drop in supply and fewer new listings in the Autumn Market, and, finally, all the distractions of the Holiday market will be punctuated with the lowest demand of the year and few homeowners opting to sell.
- **Closed Sales** - the number of successful, closed sales will be similar to 2015 levels. There will be a similar number of "move-up" sellers, which will prove to be a wise decision as mortgage rates rise in the future and affordability starts to erode.
- **Distressed Inventory** - the distressed inventory will remain low with a very similar level of successful short sales and foreclosures, representing just a few percent of all sales by year's end.

The bottom line, 2016 will feel a lot like 2015. Buyers will be lining up to take advantage of the end to low rates. The Fed will make most of their moves after the busiest season of real estate activity, the Spring Market, so the impact on Orange County housing will be minimal in 2016. The market will move from a hot seller's market for the first half of the year, to a market all about price. Pricing will be fundamental in order for sellers to find success in the second half of the year.

Happy New Year!

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I subscribe to **The Orange County Housing report** written by **Steven Thomas** of **Quantitative Economics and Decision Sciences.** I find it a very useful tool to stay informed on the Orange County CA market.