What Could Happen When the Economy Improves in 2004

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A stronger economy in 2004 may not be the cure-all for every sector of business. Wagner examines the housing sector and predicts the effects of rising interest rates and more balanced markets. A stronger economy may have a negative effect on relocation homesale programs and inventory, according to Wagner.

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After 10 years of generally robust residential real estate markets, a time bomb could be ticking in the housing industry. In some areas of the country, double-digit annual appreciation has been the norm. In the early 1990s, homeowners were hoping to meet the "3 percent appreciation per year" rule of thumb. In November 2003, existing median homesale annual appreciation was at 5.9 percent, according to the Meyers Group, an independent research firm in Costa Mesa, CA. The northeastern part of the United States presently is enjoying a whopping 13.1 percent annual appreciation rate.

The current real estate cycle has disillusioned us by offering a false sense of security. Many experts are predicting a slight slowdown in new construction and a downturn in existing homesales volume in 2004, but continued market strength and appreciation.

The recent recession that began in 2001 was the first in which interest rates were reaching record lows. Often called the most powerful man in America, Federal Reserve Chairman Alan Greenspan nearly single-handedly saved a sputtering economy from a depression with low-interest rates, which has affected real estate positively. This was during an economy in which many people lost jobs and personal fortunes in the stock market.

The record low-interest rates have sugarcoated the real estate markets, which will have an effect at some point in the relocation industry. Often a reason for a transferee's reluctance to move is that they do not "want" to leave where they currently live. Perhaps it will soon be they "cannot afford" to move, but more on that later.

Low Rates Are Bad?
How could anybody criticize the record low-interest rates that we recently enjoyed? Low-interest rates have:

- allowed approximately three-quarters of American homeowners to refinance at a lower rate, allowing them to pay less in interest over the life of their loan, sometimes saving tens, if not hundreds, of thousands of dollars;

- allowed tens of thousands of renters to realize the American Dream—to own their own home, as the homeownership rate reached its highest total in five decades—66.2 percent in 2000, according to the U.S. Census Bureau. As of the third quarter 2003, that rate reached a record 68.4 percent, according to the Meyers Group, a residential real estate research and consulting firm in Costa Mesa, CA;
- allowed many corporations and governmental entities to refinance existing debt at a lower rate to save millions of dollars; and
- helped many professions prosper, especially those related to real estate, such as the lending industry, real estate brokerage, and real estate appraisers.

The low-interest rates have fueled homebuyer motivations, and conversely an increase in those rates could lead to a decrease in sales volume, potentially leading to an increase in supply or a decrease in demand in the next year or two. This would exert downward pressure on homesale prices.

Housing Sector Challenges

There has been a lot of talk of a "real estate bubble" in recent years. Some buy into it, some do not. Many of the organizations debunking the bubble are real estate-related organizations. There are several hints, clues, and indications as to why we may be facing potential trouble. It will not be doom and gloom as the economy improves in an election year, but the housing sector is going to be faced with new challenges.

Unemployment is still high, and salaries have been declining for three consecutive years. According to the Meyers Group, as of November 2003, unemployment was at 5.9 percent, which equates to approximately 8.7 million Americans without jobs. As of September 2003, the median income was $42,409, which represents a 1.1 percent decline from the previous year. Salaries and economic growth have not kept up with the increasing rate of home values.

Personal bankruptcies continue at record levels. More than 1.6 million people filed for personal bankruptcy in fiscal year 2003, according to a Administrative Office of the U.S. Courts report published in November 2003. This number has nearly doubled in the past decade. Continuing the record-setting pace of recent years, personal bankruptcies rose 7.8 percent in the 12 months ending September 30, 2003, according to the same report.

Foreclosures remain high. According to a December 2003, report released by the Mortgage Bankers Association of America, 1.12 percent of borrowers faced the loss of their homes for non-payment, which is down from the first quarter 2003, when this rate was at an all-time quarterly record of 1.20 percent.

These issues may not impact your transferee directly, but it will pressure real estate markets in a way that could have an adverse affect.

Homeowners are refinancing at lower rates, but increasing debt. Many homeowners have leveraged their debt to survive during this recession. Unemployment has hit the middle management, white-collar employee especially hard, not to mention disappearing benefits and pensions, shrinking 401(k)s and falling stock portfolios, which have affected millions of Americans. The good news is the stock market has improved, with the Dow Jones Industrial reaching 10,000 at the end of 2003. The bad news is many of these

homeowners leveraged every ounce of their existing debt into their refinancing or their home equity lines of credit. Home values may not increase at the rate of the recent past. Furthermore, some homes may be overvalued in the marketplace by the lending industry.

Homeowners have had the ability to refinance over the past several years and draw out the equity on their homes. The refinance is not saving them money as they are spending more by paying off credit cards at the high 15 percent rates into the 30-year mortgage with a 5 percent rate. They are leveraging their current and future position into their home, often counting on the appreciation they have seen in the past decade. While the 125 percent loans are not as popular as they were a few years ago, there is a considerable amount of 100 percent loans as well as a popular 103 percent loan on the market right now. This, combined with any possibility of overvaluing of the property, or a decline in the real estate market, creates a potentially serious problem.

Overvaluing residential real estate by the lending industry is a serious concern. There has been a great deal of attention regarding lender pressure on appraisers to hit their values, especially pertaining to predatory lending and fraud schemes. It also should be noted that bad appraisals are sometimes to blame, but there have been changes in the lending industry that also contribute to overvaluation.

One change is through the shorter/quicker service of a drive-by appraisal or the use of a computer-generated automated valuation model (AVM). The mortgage lending industry has taken a position in the past decade to lend on a borrower's FICO scores and ability to repay, and placing less emphasis on the home as the collateral asset that they are lending on.

This has led the lending industry to accept alternatives to appraisal valuations, which include relying partly or solely on an AVM. These models have come a long way since their introduction, and major lenders and those who purchase loans (such as Fannie Mae and Freddie Mac) are relying on them today—-but they are far from perfect. Technology allows an AVM to take into consideration various pieces of data, including the area's recent sales ("recent" sometimes being a year or greater), as well as physical data from the local taxing body's records, e.g., property assessors.

AVMs Are Here to Stay

AVM technology is here and it is improving. It is a formidable opponent to the "human" appraiser, but also a valuable tool if used correctly in the appraisal process. It is gaining acceptance and popularity in all avenues of real property valuation and they are sometimes accurate, sometimes inaccurate, and grossly off at other times.

These AVMs are for longer-term decision-making such as a mortgage loan on a property. While they can verify some of the physical characteristics and sales date/price of a property, they certainly do not take into consideration many of the most important factors that comprise the accuracy demanded in the short-term decision-making a relocation appraisal demands on a property's value.

The AVMs cannot:

- analyze what kind of physical condition a property may be in;
- know what kind of features or improvements a property has in it that can make a value higher or lower;

- interpret adverse or attractive locations and views;
- react to functional deficiencies in a property;
- analyze supply and demand and inventory levels; or
- comprehend the effect of competition (other listings).

And most important, AVMs fail to interpret one of the key differences in relocation appraisals and other appraisals—the definition of anticipated sales price versus market value.

What Is Ahead?

As this country comes out of the recession, the economy more than likely will experience job growth. As the demand for quality workers increases, it will be imperative for corporations to attract the top talent. That will include relocating existing employees and bringing in new hires. The biggest immediate concern for the relocation industry, in terms of the residential housing market, should be the effect of the expected rise in interest rates. This impact will affect a transferee's willingness to move and ability to buy, as well as the downward pressure on existing home values.

What is going to happen when a transferee finds out that he or she is in a negative equity position? This will happen when the relocation appraisal is ordered, or the real estate agent does a market analysis and discovers that the transferee has a mortgage loan far greater than their home's value. In addition to the stress it will bring to the family situation, it may create reluctance toward moving.

There will be a few reasons for this problem, the first described previously, such as liberal lending practices and/or homeowner leveraging debt against the home. The other reason will be attributed to slowing market appreciation combined with increasing interest rates.

In some cases, a short supply of homes has fueled rapidly increasing property values. Some buyers may have paid top-dollar, or even overpaid in the marketplace. And, at that point, their home probably was worth the price they paid because of supply and demand.

If a transferee did not buy "smart," but bought something that was "all they could afford in that area at that time," they also could be set up for a tremendous letdown. As properties move from being in an undersupplied marketplace to a balanced or oversupplied marketplace, the scales will tip out of favor. For example, a busy street influence may be overlooked in an undersupplied, or a seller's real estate market; but in the balanced or oversupplied market where there are many more homes to choose from, that busy street influence may penalize the property's value at a much greater price.

Another thing affecting the potential bubble burst will be rising interest rates. In August 2003, home mortgage rates hit rock bottom and began to increase. That significantly cooled, if not "killed" the refinance market almost overnight. What will happen when rates eventually rise to the levels they were in 2000? Let us not even think about the early 1980s when the rate reached as high as 18 percent. As mortgage interest rates rise just one or two percent, it is going to immediately affect the way buyers can afford housing.

For example, a $1,500 mortgage payment, based on a 30-year loan at 5.5 percent rate, the loan amount would be $264,000. Based on an 80 percent loan-to-value ratio, that would mean a homeowner could afford a $330,000 home.

Let us hypothetically predict that the interest rate will increase to 6.6 percent in 2004 (according to a December 2003 Freddie Mac prediction), and then up to 7.5 percent in 2005. The economy will be thriving once again, unemployment will be down, our stock portfolios and retirement funds will be looking better, the Gross National Product will be up, and all will be well.

Based on that same $1,500 monthly mortgage payment at the predicated 6.6 percent rate on a 30-year loan, the homeowner only will be able to afford a loan of $235,000, or at 80 percent loan-to-value, a home priced at $293,500. That is nearly a 12 percent difference in purchase price. The day the interest rate reaches 7.5 percent again, that $214,500 loan will allow for a $268,000 home (If the mortgage rate ever reaches 18 percent again, you can expect a $1,500 monthly mortgage payment to give you a $99,500 loan, or a home valued at $124,500.).

These hypothetical numbers are based on a modest loan; the difference is obviously much more substantial in upper price brackets, which, in turn, will severely affect those markets.

Relocation Cautions

The word of caution to the relocation industry is pay attention to your home-purchase program. A better economy will lead to increasing interest rates, which may in turn affect real estate markets from coast to coast. Rising rates will affect a homeowner's ability to buy a comparable home at the new location, which will, in turn, result in only being able to afford a lower priced home. This may increase the likelihood of a transferee's reluctance to move. Rising rates will affect already undersupplied markets in lower price ranges, exerting downward pressure on prices in upper- and middle-price ranges.

It will be very important for the employer to protect against inventoried homes and resale losses by taking a hard look at their suppliers. Make certain that your suppliers, such as real estate brokers and appraisers, are qualified to interpret these market nuances with a proven track record of experience and service.

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