

The Santa Clara Real Estate Market

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Our current Real Estate market is imperfect, inefficient and inelastic.

Perhaps the most damaging is Real Estate transactions occur in an imperfect market in which buyers and sellers make decisions on incomplete, sometimes hidden information. It is an inefficient market in which supply and demand are rarely in balance. Builders overbuild in a sellers market lagging unfulfilled demand. It is inelastic as prices have deflated without a corresponding increase in sales volume.

Most everyone is familiar with the term, Market Value. It is most often a trailing value. Sometimes called Fair Market Value and comparable value. It is most often based on the last transaction price paid for a similar item with equal utility. It can be unimproved land, a house, a car, even a candy bar. It assumes a number of caveats such as being an open market transaction settled with cash or its equivalent, with full disclosure amongst the parties, none of whom are under distress.

Trailing market value is based on the last transaction price paid. Granted, there will be variations based on influences such as buyer/seller motivations, market familiarity, etc. But all and all, market value in a perfect world, is based on the open market price one pays for a similar product with comparable availability, utility and motivations.

What one pays today will change tomorrow due to influences including economic uncertainty such as varying interest rates, employment/unemployment, one's personal financial situation, and simple supply and demand. Clearly those buying the last Tulip bulbs felt great joy until the market collapsed. Buying a house, unlike a Tulip, generally includes a mortgage with global financing that includes additional market forces influencing value.

Typically, the "For Sale" housing inventory drives pricing. When supply is plentiful, as it is in the current buyers' market, prices run to lower levels compared to periods of limited inventory in a sellers' market. This is simple supply and demand. In past real estate cycles, available inventory could readily be seen via "For Sale" signs, newspaper ads and real estate listing services.

Today, these indicators are misleading. The banking and mortgage industry learned a valuable lesson at the start of the 2007-2010 recession when they collectively rushed to dispose foreclosed bank owned real estate (REO). Their abundant REO inventory flooded the real estate market destroying underlying market value. In the succeeding years cascading price decreases expanded from neighborhood pockets to regional communities erasing homeowners' equity and driving market value below owners' mortgage balances.

Today, REOs and short-sale listings are common place. These “distressed” properties compete with non-distressed listings/sales at varying discounts to “market value”. In some locales, the market *IS distressed properties*. Los Banos, Modesto and Elk Grove, California are such examples.

Unfortunately there is another growing real estate monster called Shadow Inventory.

Shadow Inventory

In an effort to avert repeating the 2007 real estate market crash, the banking and mortgage industry are controlling the distress real estate market flood gates. In so doing, their Shadow Inventory is growing.

The Shadow Inventory is distress real estate not yet offered for sale. For the most part, the owning institutions are in a struggle to dispose of their distressed properties without deflating their balance sheets by killing the real estate market. Too much of anything, can be a bad thing...

How much Shadow Inventory is waiting to flood our markets?

On March 30, 2011, John Gittelsohn of the Bloomberg News reported:
“About 1.8 million homes that are delinquent or in foreclosure loom as additional supply for the struggling U.S. housing market, according to CoreLogic Inc.

The so-called shadow inventory amounted to a nine-month supply of properties as of January, about the same as a year earlier, the Santa Ana-based real estate data service said in a report Wednesday...

Oliver Chang, a San Francisco-based analyst at Morgan Stanley, and Laurie Goodman, an analyst at Amherst Securities Group in New York, have estimated that the U.S. shadow inventory includes as many as 8 million properties. ”

The amount of Shadow Inventory is unknown. What we do know is foreclosures continue to occur at an alarming rate, increasing the Shadow Inventory.

On March 17, 2011, Pete Carey wrote in his “Housing sales flat in Santa Clara County” San Jose Mercury News story:

...”A total of 803 detached, single-family homes changed hands in Santa Clara County in February, four fewer than in January, and one less than in February 2010. That's 22.7 percent below the average February in records going back to 1988, DataQuick said...

...In Santa Clara County, foreclosures and short sales were 45.8 percent of the single-family homes sold, and in San Mateo County they were 38.8 percent, DataQuick reported.”...

How are distress sales impacting our real estate market values? How would the real estate market fair if the banks and mortgage companies release their Shadow Inventory?

In looking for possible answers, let's review some Santa Clara County real estate market charts spanning the last ten years. Zillow.com single family homes (SFR) data is used unless otherwise noted.

Chart 1 shows the ramp-up in foreclosures as a percentage of all SFR homes in the county. It peaked in September 2008 at .1935% (nearly 2 per 1,000 units). Prior to 2007, the foreclosures rate is near zero percent.

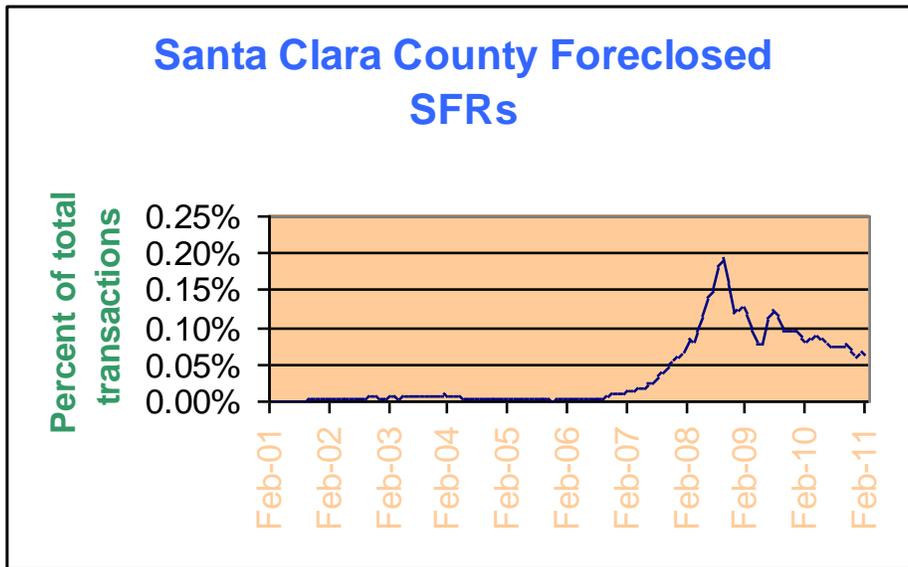


Chart 1

Chart 2 depicts Median Sale Price per SF. Foreclosure transactions are excluded to show their impact on non-distressed SFR pricing. Chart 2 shows a reduction to a \$320 per SF median price as of February 2011 from a \$500 mid-2007 peak SF price. In looking at the chart, one can see price levels have return to 2003 levels.

In reviewing chart 2, one can also see seasonally cycles with selling price typically increasing in the early spring. Price levels appear to peak in late summer and decline in the fall.

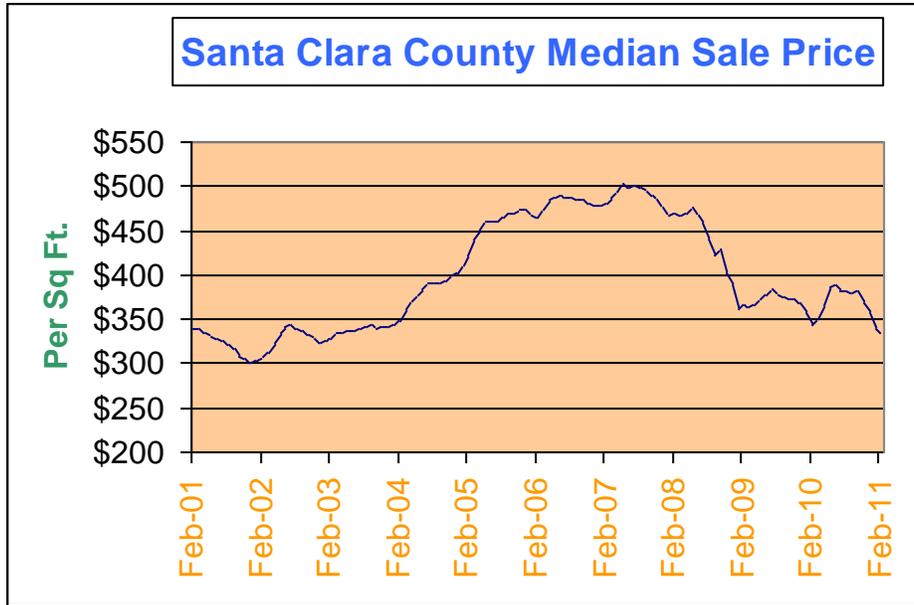


Chart 2

Chart 3 presents the loss percentage for resold homes from their previous sale price (repeat sales comparisons). What is important is the trend since late 2007 that is due to increased foreclosures as seen in chart 1. The recession and record setting unemployment have since compounded distressed inventory levels, resulting in further price declines in a cyclical cascade.

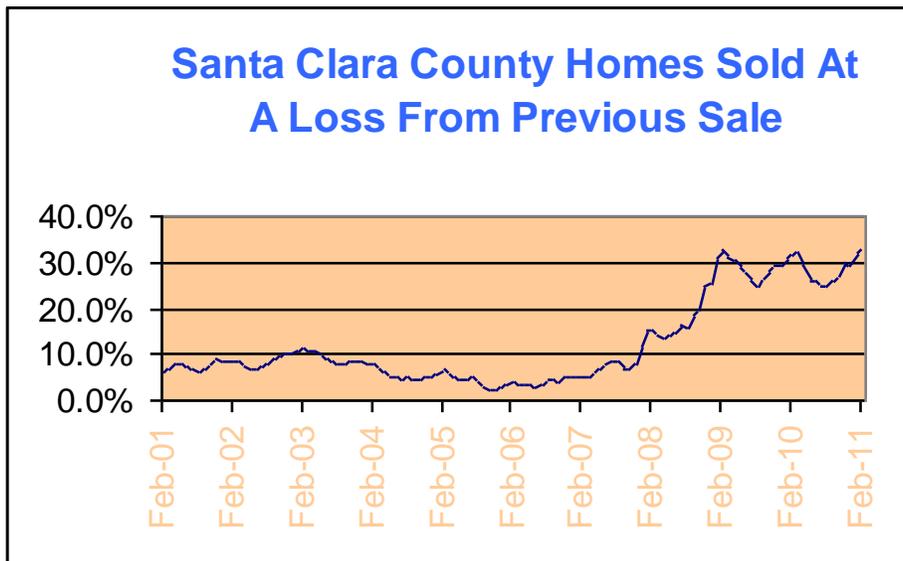


Chart 3

We have seen that Santa Clara County housing prices have returned to 2003 levels on a square footage basis for the overall county. This is a 36 percent decline since the price

peak in mid-2007. It is clear that distress properties are dictating the real estate market. The depth of their influence varies by location and excess inventory levels. Any significant release of Shadow Inventory will exacerbate the 2008 period price drop, further eroding market value.

Economic Pressures

Interest Rates

In mid-2007, 30-year, fixed interest rates started dropping as the Federal Government and Federal Reserve Bank economic stimulus programs commenced. With the over night Federal Reserve Discount Rate near zero since late 2008 (chart 4), mortgage rates struck a 4.23% low in July 2010 per Freddie Mac (chart 5). The year-to-date 2011 average 30-year mortgage rate is 4.85% as of March, down from 7% in 2001. The reduced housing prices and mortgage rates have reduced the overall home purchase cost.

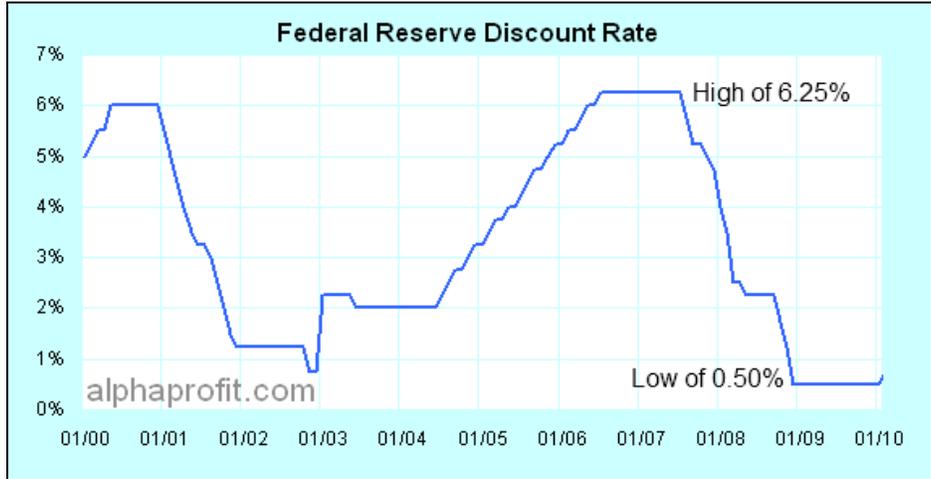


Chart 4

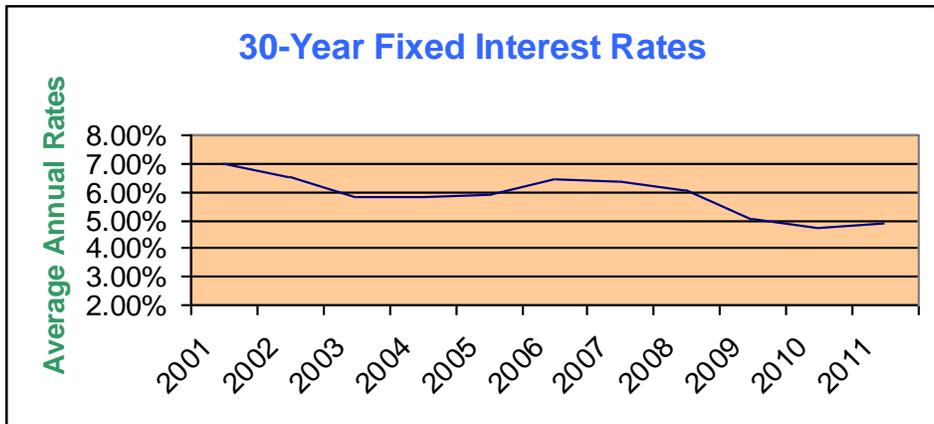


Chart 5

Normally, the combined effect of lower housing prices and interest rates result in a buyer affordability increase that should also create more demand. Unfortunately, tight credit and high unemployment have dampened the housing recovery. For the most part, the limited numbers of buyers seeking real estate are able to negotiate favorable purchase prices. And all-cash offers are increasing as investors seek profitable investments.

Inflation

The cost of consumer borrowing will become more expensive as increased inflation forces the Federal Reserve to boost their short term rates.

Recently, the European central bank increased interest rates due to the appearance of inflation as measured in raising commodities prices. Grains, metals and energy are the most notable. China has raised its lending rates repeatedly in the past year to warn off increasing inflation. Yet, U.S. rates remain at all-time lows as does the value of the dollar compared to global currencies.

The Federal Reserve states U.S. inflation is within their monetary parameters. Chart 6 from InflationData.com, shows the monthly U.S. inflation rate of change. It is built upon the Consumer Price Index (CPI). The Feb/Mar 2011 increases acknowledge raising gasoline prices. Gold has also increased to an all-time high of \$1,508 per ounce (April 22, 2011) as investors seek inflation protection.

InflationData.com														Current Annual Inflation Rate	
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Ave		
2011	1.63%	2.11%	2.68%	NA	NA	NA	NA								
2010	2.63%	2.14%	2.31%	2.24%	2.02%	1.05%	1.24%	1.15%	1.14%	1.17%	1.14%	1.50%	1.64%		
2009	0.03%	0.24%	-0.38%	-0.74%	-1.28%	-1.43%	-2.10%	-1.48%	-1.29%	-0.18%	1.84%	2.72%	-0.34%		
2008	4.28%	4.03%	3.98%	3.94%	4.18%	5.02%	5.60%	5.37%	4.94%	3.66%	1.07%	0.09%	3.85%		
2007	2.08%	2.42%	2.78%	2.57%	2.69%	2.69%	2.36%	1.97%	2.76%	3.54%	4.31%	4.08%	2.85%		
2006	3.99%	3.60%	3.36%	3.55%	4.17%	4.32%	4.15%	3.82%	2.06%	1.31%	1.97%	2.54%	3.24%		
2005	2.97%	3.01%	3.15%	3.51%	2.80%	2.53%	3.17%	3.64%	4.69%	4.35%	3.46%	3.42%	3.39%		
2004	1.93%	1.69%	1.74%	2.29%	3.05%	3.27%	2.99%	2.65%	2.54%	3.19%	3.52%	3.26%	2.68%		
2003	2.60%	2.98%	3.02%	2.22%	2.06%	2.11%	2.11%	2.16%	2.32%	2.04%	1.77%	1.88%	2.27%		
2002	1.14%	1.14%	1.48%	1.64%	1.18%	1.07%	1.46%	1.80%	1.51%	2.03%	2.20%	2.38%	1.59%		
2001	3.73%	3.53%	2.92%	3.27%	3.62%	3.25%	2.72%	2.72%	2.65%	2.13%	1.90%	1.55%	2.83%		
2000	2.74%	3.22%	3.76%	3.07%	3.19%	3.73%	3.66%	3.41%	3.45%	3.45%	3.45%	3.39%	3.38%		

Note: Red indicates Deflation, NA indicates data not yet released.
[Get more Historical Data from InflationData.com](http://www.inflationdata.com)

Chart 6

In reviewing chart 6 one can see economic cycles as viewed through inflation. In addition to the Mar-Oct 2009 negative inflation period, the 2002 recession is apparent as inflation rates approached 1 percent and recovery followed. In chart 4 we saw the Fed was aggressive in the mid-2004 to mid-2006 period raising rates 9 times, only to reduce to historical lows in just over a year as the economy crashed.

Our recent recovery has excluded housing. Employment improvement has been a pittance compared to previous recession. The longer the Fed waits to increase their rates, the greater the opportunity for the U.S. economy to strengthen. However, waiting too long will aggravate inflation and ultimately reduce consumer purchasing power. Inflation will increase the cost of mortgage money. As a result, buyer affordability barriers will emerge; forcing sellers to further reduce their asking prices. Shadow Inventory will also contribute to the drama.

If you are unemployed, obtaining a job makes a wonderful difference. When the economy improves, we feel better. An improving stock market and economy leads to improved consumer sentiment. An improving economy also brings inflation. For those with money and/or real estate, a little inflation is good. It is healthy for the economy as modest inflation promotes near-term purchases and investment as prices increase.

Inflation can also hinder real estate purchases as financing costs increase. In an improving economy, loan interest rates increase, reducing borrowers' disposable income. At least until lagging earnings increases.

Employment

While fear of economic and employment uncertainty persist, employment is starting to improve.

On April 15, 2011, the California Employment Development Department (EDD) reported March unemployment rates of 8.8% for the U.S., 12% for California, and 10.3% for Santa Clara County. This is a decreased from year ago, March 2010 levels of 10.2% for the U.S., 12.4% for California, and 11.7% for Santa Clara County. Ref: www.edd.ca.gov

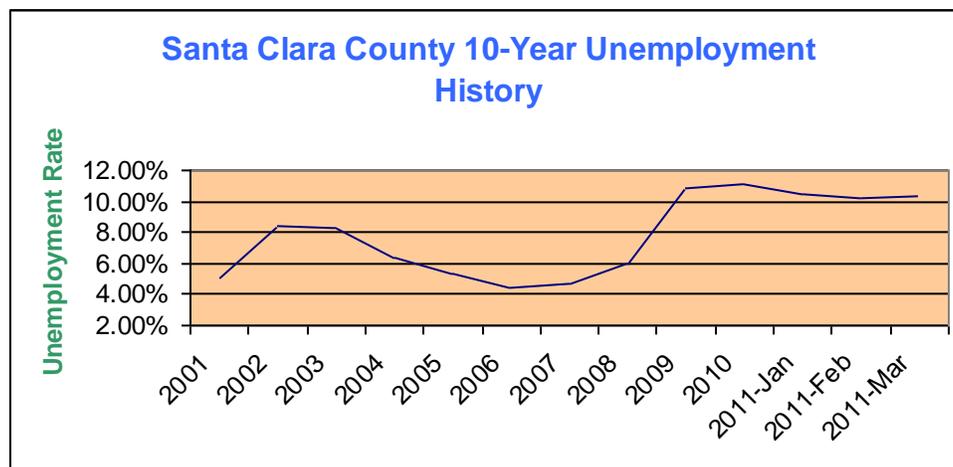


Chart 7

Santa Clara County employment is still on life support. Government agencies, school districts and other employers dependent on tax dollars continue announcing layoffs. In

late April the City of San Jose announced 600 potential layoffs will take place in June 2011 as they try to balance the city budget.

Past recession recoveries were lead by consumer spending. Our factories resumed production and employers rehired as the U.S. exported its way to economic prosperity.

Unfortunately, the majority of job growth in recent years, the engine of our economy, is occurring over seas. This alarmist statement is the topic of much political and economic speculation and embellishment. It is a fact that U.S. employment has fallen. It is also a fact the U.S. imports more than it exports as chart 8 clearly shows.

On April 12, 2011, the U.S. Census Bureau reported our international trade deficit decreased to \$45.8 billion in February from \$47 billion in January 2011 “as imports decreased more than exports.” Ref: www.census.gov/indicator/www/ustrade.html

Chart 8 is from the U.S. Census Bureau’s web site. It depicts U.S. International Trade since February 2009. Yes, the \$45.8 billion is a decrease from \$47 billion. However, I believe the more salient point of this chart is the changes for the two year period in which imports grew 72.5% from \$153b to \$211b and U.S. exports grew 77% from \$127b to \$165b.

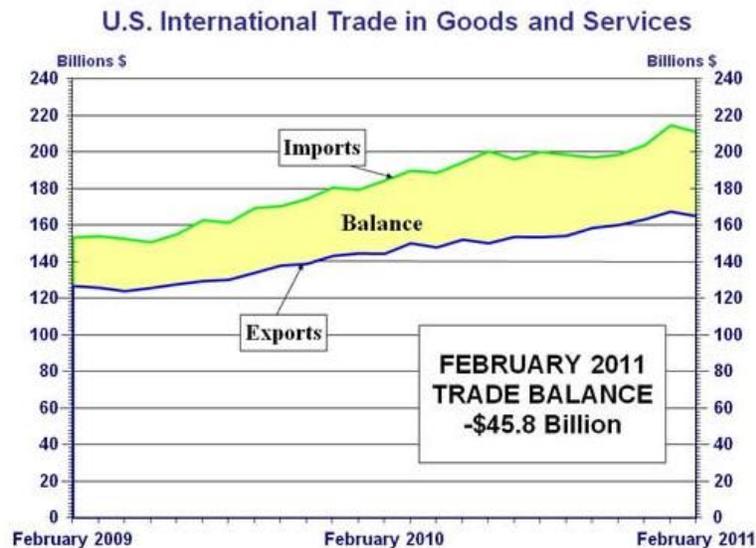


Chart 8

How much will U.S. exports grow?

Chart 9 presents U.S. Department of Commerce BEA information from the International Economic Accounts web site at www.bea.gov/international/index.htm#omc. The chart depicts global regional employment and sales growth for the 1999 to 2008 period.

Country of residence of U.S. based MNC affiliate.	Employment Growth 1999-2008	Sales growth excluding U.S. import, 1999-2008
U.S.	-8.3%	45.1%
Canada	6.0%	136.4%
Europe	19.3%	122.7%
Latin America	26.0%	146.8%
Asia-Pacific	74.5%	177%
Total non-U.S.	30.4%	139.8%

Chart 9

Not surprising, U.S. employment growth is negative for the '99 to '08 period. Note that the prevalent employment growth is in the regions with the higher sales growth.

The U.S.'s employment base has diminished recently due to the current recession and over a lengthy time period as U.S. based corporations increased their overseas good and services production. Today, these corporations, called Multinationals Companies (MNCs) have relocated business centers to better serve their growing markets. Non U.S. based MNCs such as Nissan and Toyota have in turn placed manufacturing centers in the U.S. Unfortunately, our recession impacted the work force at these facilities as well.

Without a doubt, MNC production costs are less in many locations abroad, affording them greater profit. U.S. production of goods and services for export has decreased (as a percent of the total market). This decrease in U.S. based manufacturing has idled workers and forced factory closing.

Neighborhood Watch

The housing crash and recession brought new meaning to the term Neighborhood Watch. Today it includes watching neighborhood real estate market values. As previously discussed, distressed properties severity impacted neighborhood real estate values.

Various internet based services are available to gauge real estate health. The local Multiple Listing Services provides tools to real estate professionals. Unfortunately, private sales and most trustees' sales take place outside of MLS. Information service companies such as DataQuick, publishes abundant real estate metrics that include private transaction. Ref: www.dqnews.com. Additionally, the San Jose Mercury Newspaper publishes the weekly DataQuick real estate activity report each Saturdays in the Real Estate Section.

Zillow.com also provides considerable information. A very useful real estate market health report using Zillow.com data is provided through the San Jose Mercury newspaper. This easy to use web tool allows one to select areas by region, city or zip code within the greater San Francisco Bay area. Check the health of your community at www.mercurynews.com/realestatenews/ci_11614096?source=email&nclick_check=1

Chart 7 below presents a 95111 zip code search. As you can see, the real estate market in this San Jose neighbor is damaged. The current Zindex price level has returned to

February 2000 levels and is down 38.1 percent from last year, and is down 52.9% from its peak.

County	Santa Clara
Zip	95111
City	San Jose
Current Zindex	\$305,069
Change from prior quarter	-6.3%
Year-to-year change	-38.1%
5-year change	-8.5%
10-year change	1.8%
Peak Zindex price	\$647,383
Peak Zindex price month	2007-04
Percent change from Zindex peak	-52.9%
Last month Zindex was at current level	2000-02

Chart 7

By comparison, Los Altos Hills' real estate values have returned to April 2007 levels. Current real estate values are down 7.1% from the one year ago period and down just 7.5% from its peak April 2008 Zindex.

County	Santa Clara
Zip	94022
City	Los Altos
Current Zindex	\$1,820,448
Change from prior quarter	-0.1%
Year-to-year change	-7.1%
5-year change	2.4%
10-year change	5.5%
Peak Zindex price	\$1,968,515
Peak Zindex price month	2008-04
Percent change from Zindex peak	-7.5%
Last month Zindex was at current level	2007-04

Chart 8

The Economy that Can:

The Santa Clara Valley economy is built and dependent on technology based Multinationals Companies. These firms in close proximity to centers for higher learning have developed symbiotic relationships. Their synergy had led to new technologies, products, companies, markets and wealth.

This wealth has greatly benefited our region as the affluent have been able to weather the recession, where they have buffered the recession's impact in our community. Yes, our real estate market has taken a beating when viewed as a whole. But there are many desirable communities that have returned to pre-recession levels.

Additionally, this wealth, invested into emerging business ventures is renewing our economic base. Tesla, Google, Twitter and Facebook are such examples. Older companies either renew themselves such as Apple or perish such as DEC, Wellfleet and 3Com.

Other regional communities have not fared well. But all and all, the Santa Clara Valley real estate market has fared better than many California and national regions. The greater San Francisco Bay area economy is on the mend. Low interest rates and an educated labor force, motivated to work will enable a return to prosperity. The lessons learned from the 2007-2010 recession, such as financial deregulation, the sub-prime crisis, credit crisis, banking failures, bailouts, over leveraging...will be remembered.

Locally, many challenges lay ahead that must be worked through, including, but not limited to the Shadow Inventory, state and local government budget mismatches, and high unemployment.