

# REAL ESTATE NEWS



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**DUMKE**  
Fine Homes



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## Referral Reward Program

*Every time you refer a friend or relative that sells or buys a home with us, we'll send you a check for \$250.*

## Quote

*My firm conviction is that only by studying the lessons of yesterday can investors avoid making damaging mistakes tomorrow. In no other area has history repeated itself as in the stock market.*

*Dana Thomas, historian, journalist and author.*

## Market Cycles

By John Dumke

Quite a few years ago, I had dinner with my Great Uncle. His professional career was spent in Real Estate. He was involved in the sale of many tracts throughout L.A. Co. and had done quite well purchasing Real Estate. So when he proclaimed, "It is time to buy", during our early 1996 dinner, I paid attention. He further went on to state that property always goes up in Southern California. Now wait a minute! I can understand making a call that the end of the downturn was here, but was he living under a rock? I felt it important to remind him (during our 1996 dinner) that prices had come down on average about 25%. More for high end homes and way more for income property. So how could he state that prices didn't **REALLY** drop.

His coy response to my reminding him about this 25% price drop was. "Prices didn't really drop they were just overpriced". Having him say that prices didn't really come down (they were just overpriced), was an acknowledgment that So Cal has gone through boom and bust cycles. Through his experienced eyes, he filtered out the lows and highs to see through to the markets true value. His observation was that So Cal has had cycles every 10 years and he saw nothing abnormal with what we had just been through.

Fast forward to 2005, and home prices have gone up 3 fold since the bottom in 1996. So, I thought it would be a good time to look at history and the Real Estate cycle, because as

far as I know they have not repealed the business cycle (though briefly in 1998-99 dot com investors petitioned the "Gods of Economics" to repeal the business cycle, the appeal was denied). They say history repeats itself but I think Mark Twain said it better "History does not repeat itself, It rhymes." So while I can't prognosticate the future, I can illuminate themes that rhyme with the past.

### Affordability and Creative Loans

One area that rhymes with the past is affordability. When affordability drops lenders come up with new loan programs in to help buyers with higher prices. Maybe I am more aware than the average person, but it seems we are being inundated with ads touting extremely low interest rates. Two lenders come to mind, quicken.com's smart choice loan and HMSCapital.com's 2.875% loan. Both loans big selling points are low payments on large loans. For Quicken it is only \$1,700/month to borrow \$500,000 (instead of \$3,000 @6%) and for HMS Capital it is only \$1,437/month to borrow \$600,000 (instead of \$3,600 @6%). 6% is a reasonable rate for a jumbo 30 year fixed, the traditional conservative way to finance a property.

So what's wrong with a 2.875% interest rate loan? Nothing if rates stay low. But what happens if rates go up? You don't have to look back far to when **adjustable** rate loans were 6% or higher. All that it takes would be a Libor or 11th Dist COF to be around 4% plus

## How Much is My Home Worth?

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a margin at 2 -2.25%. This scenario is very likely.

The best case scenario is the buyer can afford the home if interest rates do go to 6% for a fully indexed adjustable rate loan. In this case the buyer is simply making a substantially large interest rate bet that *short term* rates will stay below 4%. In this case then there is nothing wrong. The buyer benefits right now and this savings can go towards making up any deficit should rates go above 6% (where they could have locked in on a fixed.)

What is much more likely is the buyer is getting a 2.875% loan because they can't afford the home otherwise. This is the case for a future foreclosure. Should rates go up, they will lose the home. And short term rates moving above the 4% mark (meaning adjustable home loans above 6%) is VERY likely. Short term rates were above 4% from May 1994 - May 2001, reaching a peak of 6-6.5% (see <http://www.federalreserve.gov/fomc/fundsrate.htm>).

In addition to low introductory rates, there are other ways buyers can get into trouble. Zero down, marginal credit and undocumented income loans are a couple others. It takes 3 things to buy a home, down payment, income and credit rating. I used to tell buyers they needed two of the three. Then, in 1993 we saw 5% down loans for the first time, we were amazed. Now 0% down is common place. Then loan programs became available for buyers with bad credit (FICO scores less than 620). Now for the grand duzzy... there are 0% down loan programs for buyers with bad credit and no way to verify their income. The bottom line is now you can buy a home with bad credit, no down payment and unverifiable income. If lenders had not created these easy money loan programs to open up the housing market to very marginal buyers, might the market have cooled a lot sooner?

But why would a buyer be so willing to stick their neck out on the line by taking on more debt than they can handle in such a risky way? Because there is a greater perceived risk that the home that they are buying will be worth \$50,000 - \$100,000 more next year. But if prices don't go up, a buyer's willingness to be so aggressive may wane. Anticipated appreciation or depreciation then becomes a self reinforcing factor on either the way up or

the way down. This enhances a cycle leading to a boom and bust.

While a rising market masks problems, a falling market will bring stupid practices to light. Not until after the dot.com bubble burst did we see Enron, Global Crossing, mutual fund after hours trading, and unethical insurance brokerage practices. While the market is rising, nobody cares about fiscal responsibility, finding an audience that cares is virtually impossible.

### Markets are Created on the Margin

Markets are created on the margin, not by owners that bought 5, 10 or 20 years ago and only owe 50 cents or less on the dollar. They are created by sellers that have to sell and buyers that have to buy. Markets don't simply ratchet up like a car jack reaching a certain level which is then permanent. They are more like a glider floating on the warm upward currents of the buying public. The glider can soar high but it is contingent upon buyers enthusiastic current staying warm and contingent upon current owner already flying in the glider not becoming weighted down with excessive debt responsibility. The market is dynamic and there are no guarantees.

### So Cal Real Estate maybe more Volatile

It is quite likely that Southern California has greater volatility. The Real Estate market here has more of a boom and bust nature than in other parts of the country. It's basic supply and demand, high mobility and little area to expand. Like San Francisco and N.Y.C., the Los Angeles basin, can attract a large influx of potential workers with not enough new housing projects to satisfy demand, creating extreme price swings.

### The Ebb and Flow in and out of So Cal

Higher prices encourage relocation out of So Cal and discourage new business creation. This is one factor that keeps prices in check. While 2003 saw mostly trade up buyers staying in So Cal, the tide has finally shifted. In 2004, there were quite a few trade out buyers, moving to Colorado, Tennessee, Wyoming, all places where real estate is cheap. In these locations you can purchase a new 2,500sf home for around 175-250k. When you are sitting on a 1,200 sf tract home worth 450-600k,

# Market Activity

The following information is from the Multiple Listing Service as of 12/18/2004.

Address	Br/Bth	Sq Ft	Lot Size	List Price
<b>Alamitos Heights</b>				
380 Ultimo	3/3	1691	3250	680,000
339 Flint	3/2.5	2242	3250	699,999
394 Ultimo	3/2.5	1691	3250	749,900
388 Ultimo	3/2.5	1691	3250	767,400
775 Havana	3/2	1850	6400	839,000
626 Ultimo	3/3	2325	6500	885,000
933 Terraine	4/4	2400	5460	1,099,000
329 Manila	3/4	2705	4146	1,250,000
621 Havana	4/4.5	6419	9750	2,495,000
936 Santiago	2/2	2120	6890	889,000
308 Flint	4/4	2948		1,200,000
<b>La Marina Estates</b>				
1390 Hackett	2/2	1794	8360	639,900
<b>Los Altos (S. Fwy)</b>				
5481 Daggett	2/2	1134	6300	420,000
6982 El Cedral	3/2	1038	5580	450,000
2156 Stanbridge	2/1	862	5775	459,000
2136 Fidler	2/1	859	5775	470,000
6400 Madera	3/2	1077	6104	485,000
1866 Knoxville	3/1	1084	6882	470,000-490,000
5211 Daggett	2/2	1478	5775	495,000
5836 Garford	4/2	1497	6650	499,000
2036 Greenbrier	2/1	1506	5775	510,000
2261 Ocana	3/2	1498	6028	515,000
6932 El Roble	3/2	1039	6608	519,500
6400 Fairbrook	3/2	1198	5665	520,000
6200 Fairbrook	2/2	1487	6420	525,000
2150 Senasac	2/1	1045	6380	525,000
1833 Marber	2/2	1446	6235	529,900
5343 Abbeyfield	3/2	1301	5775	575,000
1408 Vuelta Grande	3/2	1462	5580	578,000
5804 Garford	3/1	1622	6450	584,000
1414 Vuelta Grande	3/2	1617	5580	595,000
2077 Fidler	3/2	2000	5775	615,000
1851 McNab	3/2	1800	6599	624,900
2114 Tulane	3/2	1698	7200	629,000
2044 Carfax	3/1.75	1292	5985	639,000
1849 Tulane	3/2	1745	5500	595,000-645,000
5434 Garford	3/2	1786	6300	649,000
1811 Tevis	5/2	2018	6720	675,000
2178 Albury	4/2.5	1945	6200	699,900
5901 Garford	4/2.75	1832	6090	699,900
1885 Lave	3/2	1700	6080	709,900
<b>University Park Estates / College Park</b>				
872 Stevely	3/2	1517	9290	599,800
804 Lees	4/2	1587	6140	629,500
845 Lees	3/1.75	1517	6270	639,000
6850 Lees Way	3/1.75	1517	5985	675,000
6861 Roxanne Way	4/2	2064	6470	685,000
361 Silvera	4/2	1688	6380	695,000
6219 5th St	3/3	2301	6450	715,000
311 Linares	4/2	1996	6867	725,000
6255 6th St	4/2	1692	6850	759,000
551 Margo	4/4.5	3069	7250	899,000
<b>Park Estates</b>				
1411 Greenbrier	3/2.5	2562	6900	715,000
5576 Oleta	3/2	1777	8183	739,500
5464 Oleta	3/2	1970	8450	743,900
5231 Vista Hermosa	3/1.75	2031	8090	895,000
5241 El Roble	3/2	2241	10500	949,000
5550 El Parque	3/2	2210	10240	1,250,000
5371 El Parque	4/3	2888	15040	1,725,000

## IRS Rules Change

*The IRS recently modified the rules for the sale of a principal residence acquired via a 1031 exchange.*

*Effective 10/23/04 a principal residence originally acquired via a 1031 tax-deferred exchange must be owned for at least 5 years in order to claim an exemption.*

*The rules are now:*

*Ownership - 5 yrs.*

*Use as principal residence - 2 yrs.*

*Time since last exclusion - 2 yrs.*

## Quote

*Wall Street learns nothing and forgets everything.*

*Benjamin Graham*

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## Inside

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### How Much is My Home Worth?

### IRS Changes Rules for sale of principle residence aquired through 1031 Exchange.

### Market Activity: What's happening in your neighborhood?

it makes it pretty hard not to at least consider relocation as an alternative. This trend is likely to remain as this has been the first year of this trend.

#### The Media as a Reverse Barometer

The media usually can be a reverse indicator. Remember Time Magazines Man of the Year for 2000? It was Jeff Bezos CEO of Amazon.com, just in time to sell your internet stocks. Now we have Donald Trump back in the mix and famous as ever. Donald's first book was published in 1987 right about the time real estate was peaking in N.Y. The stock market crash in Oct 87 marked a peak in N.Y., while California moved higher for another 3 years.

#### The Fed - Robbing Peter to pay Paul?

The Real Estate market, along with consumer spending (as a result of home equity and refinancing) has bailed the economy out of the stock market crash and subsequent recession. It has done this with artificially low interest rates. Short term interest rates have yielded a negative real return, meaning that inflation is greater than the interest rate you earn at the bank. On top of that there are quite a few experts that think the fed is cooking the books to make inflation look tame.

This creates two problems. First it moves future activity to the present. Just like the auto industry, incentives get buyers to buy now rather than later. But now that they have a new car, they won't be buyers next year.

There is a second issue created when the fed brings rates to rock bottom. It promotes investors to bid up the price of other assets in search of yield. Would you be happy earning 1-2% in the bank? Imagine having a million dollars in the bank and only collecting interest of \$12,500 annually (1.25% interest). You would be pretty frustrated and search for alternatives. But if that same million dollars returned 6% or \$60,000 annually you wouldn't be so motivated to go buy an apartment building with marginal cash flow. Artificially low interest rates force investors to overpay for investment vehicles such as income property.

#### Market Psychology and Expectations.

They say that prices climb a wall of fear and go down a slope of hope. So at market tops there is no longer fear, just greed. Yet as prices

start dropping, there is disbelief, and a firm conviction that things will get better. Then when it's clear that things won't get better there is a sharp drop in prices. Towards the bottom of the market there is resignation that things won't be getting better anytime soon, and just as there is no hope left, the market turns around and starts getting better.

At the bottom the market in 1994-1996 sellers were so beat up that they just hoped they could sell their home. Price was not an issue. Today there is more greed in the marketplace. As I wrote last quarter prices had gone up 29% in Los Angeles from March 03-March 04. When a 450k home goes to 600k, some homeowners figure it should keep to 650k ... right? Since home prices have been growing at a huge pace, there certainly is overconfidence in the market to deliver and this promotes greed. A symptom of a market top. But trees don't grow to the sky.

In my last newsletter I wrote that the multiple offers had stopped and supply and demand were now about even producing a 10% drop from the frenzy of the multiple offer mania. Yet I notice some markets where list prices are still wildly over-optimistic.

While the market is taking a breather from further gains, by no means is a drop in prices inevitable. By contrast the 1990-1995 bear market in So Cal Real Estate was pretty rough. The drop in defense spending was significant and it really hurt the region. During the early 90's drop, I spoke to many agents with over 15 years in the business and those agents did say that 92-93 was the worst downturn they ever saw.

On the flip side, in Wall Street terms, they say that the strength of a pull back in prices is proportional to the strength of the move up. There is no doubt that since 1996 the strength has been pretty overwhelming, so we could give back a little.

What happens as we close out this chapter in Real Estate is anybody's guess. But clients should be aware that So Cal Real Estate does have a strong housing cycle and the great strides Real Estate has made may require a breather.