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It’s Time To Start Worrying About The Housing Market Again

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IT'S TIME TO START WORRYING ABOUT THE HOUSING MARKET AGAIN

At the end of 2017, I published this post on why we should start worrying about the housing market again. I'm updating this article as of where things stand on July 1, 2020. It's time to start worrying about the housing market again.

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At the end of 2017, I published this post on why we should start worrying about the housing market again. I'm updating this article as of where things stand on July 1, 2020. It's time to start worrying about the housing market again.

The housing market in various parts of the country did start to soften in 2018 and 1H2019. Then by 2H2019, the housing market strengthened due to low rates and a strong stock market.

Now, in the second half of 2020, we should once again start worrying about the housing market. The reasons are clear: massive unemployment, shutdown economies, COVID-19, many jobs not coming back after the economy opens, and rising delinquencies.

In my Housing Predictions 2021 post, I state that the national housing market should soften by up to 5% in 2020, followed by a rebound to new record-highs in 2H2021.

Let's go over some more details on why the housing market is in a precarious situation in 2H2020 and beyond.

WHY WE SHOULD START WORRYING ABOUT THE HOUSING MARKET

Despite publishing cautionary posts about investing in stocks, bonds, and alternatives at current levels, the biggest caution I should be writing about is taking out massive debt to buy property at record highs as of 1Q2020.

If you lose 50% on your stock and bond portfolio, you'll be upset, but fine. If your property loses 20% of its value, however, this means you've lost 100% of your 20% down payment.

In this scenario, you'll also probably still be fine – if you don't have to sell. But when property prices correct by 20% or more, many people become forced sellers because they've also lost their jobs.

I understand that millennials are coming of buying age and inventory is on the decline, making competition for buying a home fiercely.

However, only if you are fully cognizant of the following points I've highlighted below should you proceed with a property purchase today

THINGS TO KNOW BEFORE BUYING PROPERTY TODAY

1) Rents have softened

Given property prices are a function of rental income multiples, a real estate buyer should be looking to buy at similar pricing discounts from peak rental periods.

For example, research whatever comparable New York property you want to buy today that was sold for in March 2016 and aim to buy at a 14.8% discount to the March 2016 price because that's how much rent prices are down.

In 2017 I experienced softening rents first hand when I tried to find replacement tenants for my SF rental house at a similar rent of $9,000 a month. After 45 days of aggressive marketing, I only got two offers, both for $7,500 (-16.7%).}

I even hired a rental listing agent for two weeks to find people for at least $8,000 and he failed. As a result, I sold it. Pricing pressure starts at the most expensive markets and works its way down.

The large supply of condos in many expensive cities has really put a damper on rents and housing prices.

Buying at peak prices when rents have fallen from peak levels means you are paying a higher valuation. This is a dangerous scenario that can't last forever.

2) Mortgage industry is very tight

Here's what's going on in the mortgage industry, which is as stringent as it has ever been.

Liquidity (Profitability) Concerns: A growing percentage of people are not paying their mortgages and banks are uncertain if and when payments will resume. As a result, his bank is only lending to the most financially fit customers.

Stricter Lending Standards: Due to liquidity (profitability) concerns, banks have significantly tightened lending standards. Here are some of the increased lending standards he mentioned to me:

- *Temporarily stopped allowing for cash-out refinances*
- *No longer fully counting RSU values when*
- *calculating how much a person can borrow*
- *No longer including Schedule E income (rental income) when calculating how much a person can borrow – big shocker*
- *No longer approving Home Equity Lines Of Credit (HELOC)*
- *The minimum down payment is 20%*
- *Raised minimum credit score to qualify for a mortgage to 680*

In other words, lending standards are as strict as it gets. As a result, perhaps there is an upside to real estate liquidity if there is a reversion to pre-pandemic level standards sooner.

3) Mortgage rates are back to record-lows

Despite a tight mortgage market, mortgage rates are actually back down to record lows.

My last mortgage refinance was in 4Q2019 when I locked in a 7/1 ARM jumbo ARM at 2.626%. I was pumped!

However, in 2Q2020, I was able to get preapproved for a 7/1 ARM jumbo mortgage with a 2.125%. This rate is absolutely nuts. I could have got a 30-year fixed-rate mortgage for 2.875%, but I don't plan to have the mortgage for longer than 10 years.

To take advantage of record-low rates, everybody should get a free mortgage quote at Credible. They are one of the largest online marketplaces where lenders compete for your business. All the quotes are free to use as leverage against one another.

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4) Prices have surpassed their previous peaks in many cities

While every city is different, if you look at the prices in Denver and Dallas, you'll find that the prices are roughly 45% higher than they were in 2006-2007. This price performance is similar to San Francisco's. Meanwhile, hot cities like Seattle and Portland are only about 20% above previous peaks.

The US median existing-home price is about 12% higher than its previous peak, which is a modest rise since over 10 years have passed. As a real estate investor, your goal is to invest in markets that have both underperformed and have the potential to catch up.

5) Tax reform takes time to negatively impact housing prices.

Conceptually, we all know that limiting state income and property tax deductions to $10,000 and limiting mortgage interest deductions on new mortgages up to $750,000

are net negatives for expensive coastal city real estate markets. However, it takes 1-2 years to start feeling the crunch of tax reform.

Think about it. Let's say you own an average 3 bedroom, 3 bathroom home for $1.5 million. Your property taxes alone cost $17,000 – $20,000 a month, depending on which state you reside in. Let's say you earn $120,000 a year. You'll have paid $6,000+ in state income taxes. In the past, you could have deducted the entire $23,000 – $26,000 from your income. Now, you are limited to $10,000 in deductions.

Some will argue that lower-income taxes will offset these deduction limitations. Perhaps. But nobody really knows for sure until 2019 tax returns are filed and accepted. Tax reform is a headwind, not a tailwind for coastal city property price appreciation.

6) Inventory is slowly creeping higher while rents are flatlining.

The construction boom we've experienced over the past several years is finally showing up in the data as a wave of new inventory hits the market. When there's more inventory, pricing comes under pressure.

Although inventory is still historically low, it's important to realize the inflection point we've experienced in mid-2018. In just several months, the amount of inventory is back to where it was at the end of 2012. If the trend continues, we could quickly get back to 2008-2010 levels.

Interestingly, after the shelter-in-place rules went into mass effect at the end of March 2020, inventory dropped way back down. This bigger drop in inventory than demand has helped real estate prices stay strong.

7) It takes a while to recognize a peak.
The housing boom that began in January 1996 ended in March 2006. But it wasn't until the beginning of 2008 that people started to accept that the housing market had already peaked.

Until 2008, property investors were still clinging to hope or at least were in denial that prices would no longer be going up. Once Bear Sterns was sold for nothing to JP Morgan in March 2008, people started to panic.

Then Lehman Brothers went under on September 15, 2008, a full two and a half years after the housing market peaked. And things got even worse, with the S&P 500 finally bottoming out on March 9, 2009. At least as of 3Q2020, we already experienced an aggressive 32% decline in the S&P 500 in March 2020.

Below is a great chart that shows how badly housing prices corrected in some of our major cities. Notice how the previous boom lasted 10 years and the crash lasted 5 years.

8) The stock market crashed
We saw a violent 20% sell-down in the S&P 500 in 4Q2018. Then we saw a 32% decline from peak-to-trough in the S&P 500 by March 23, 2020.

From policy errors by the Fed, to trade wars by Trump, to slowing global growth, to a potential war with Iran, to COVID-19, to a global pandemic, companies everywhere will be more cautious on their spending in 2021 and beyond.

Incredibly, the S&P 500 rebounded strongly by 2H2020 and the NASDAQ is now at an all-time high. Will it last? It's hard to say.

Just know that prices tend to revert back to the mean or overshoot on the downside very 4 – 10 years. Real estate takes 2-5 years to correct, so there is no rush to buy

RECOGNIZING SIGNS OF HOUSING MARKET STRENGTH

Although it's good to worry about the housing market again, let us also recognize that the housing market has stayed strong as of 2H2020 so far. The reasons are:

Record-low mortgage rates

- A strong rebound in NASDAQ and the S&P 500 from their March 2020 lows
- A rotation out of volatile stocks into stable real estate
- The implicit guarantee by the Federal Reserve and the Federal Government will continue to do whatever it takes to support the economy

If you can buy a home for 5% – 10% below its 2019 or February 2020 peak, it will probably feel like getting 15%+ off due to a collapse in mortgage rates.

Below shows a massive rebound in mortgage-purchase applications in May 2020. The rebound will likely stay strong so long as rates stay low and the government keeps supporting the economy.

BUY REAL ESTATE RESPONSIBLY
The mass media and the real estate industry will focus on strong demand, strong job growth, and a dearth of inventory as drivers for higher property prices in 2021 and beyond. That's fine if you can surgically buy-in strong job cities via real estate crowdfunding. If you look at property nationwide as a whole, prices will probably soften in 2020 before rebounding in 2021.

There are more deals to be had in expensive coastal cities like New York. However, I think it's best to look to the heartland instead. Valuations are much cheaper and net rental yields are much higher.

If you're dying to buy a primary residence today, make sure you can withstand a 10-20% correction over a five-year time frame. It's always good to plan conservatively.

If you don't have a financial buffer equal to at least 10% of the value of your property after putting down 20%+, then you are not financially prepared for a downturn. You need to try and buy at a price that is at least 5% lower than the previous comparable sale price.

Too much debt is really what will kill you if we ever return to hard times. Buy a house to enjoy life instead of looking to make a profit.

I doubt we'll have a correction as violent as the last one given lending standards became far tighter after the housing crisis. All the same, please buy and borrow responsibly.

By Financial Samurai
Source:
https://www.financialsamurai.com/time-to-start-worrying-about-the-housing-market-again/

REAL ESTATE RECOMMENDATIONS

Real estate crowdfunding: If you don't have the down payment to buy a property, don't want to deal with the hassle of managing real estate, don't want to tie up your liquidity in physical real estate, and are looking for real estate diversity, take a look at Fundrise, one of the largest real estate crowdsourcing companies today. It's free to sign up and explore.

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1430 W BUSCH BLVD. SUITE
D TAMPA, FL 33612.
(813) 876-4373

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