



MINNEAPOLIS AREA Association  
of REALTORS®

## **Is a regional housing bubble burst on our horizon?**

Answer your customer's bubble questions

### **Housing bubble talking points**

Much attention and concern has been given in recent months to the prospect of a local and national housing “bubble” in the news media, including the likelihood of a “bubble burst.” Due to the extremely robust nature of the Twin Cities real estate market in the last nine years and the resulting run-up in housing prices, some have wondered whether we are seeing a repeat of the “irrational exuberance” that accompanied the stock market – to be followed by a bubble burst, a swift and precipitous drop in housing sales and prices. While the prospect of such a downfall can indeed be frightening, MAAR believes that it is highly unlikely.

The following is intended to provide you with information that you can share with your clients, co-workers, the general public and media to help them understand why the Minneapolis Area Association of REALTORS® (MAAR) believes the Twin Cities residential real estate market is in good shape – and why regional bubble talk is idle speculation.

### **Why the media clamor?**

America is in love with real estate and homeownership; hence, the media has a story with legs.

Along with the rapid pace of home price appreciation, pundits cite other factors that point to the possibility of a regional or national bubble burst – such as the possibility of a dramatic rise in interest rates, the expanded use of creative financing tools resulting in a higher debt load for the American consumer, the impact of speculative buyers inflating prices and then leaving the market quickly, the prospect of struggling corporations like Northwest Airlines proceeding with massive layoffs or bankruptcy, climbing national debt, and the outsourcing of jobs overseas.

The influence of each factor will vary greatly depending on the intensity of the event. A bubble burst will likely require the convergence of numerous factors that are large in scope and all resulting in significant negative change. These factors will have to include the onset of recession across many economic sectors over a period of time.

### **First things first**

Twin City housing prices have not experienced a decline over the past several decades except for two brief and minor occasions; (1) a slight drop in 1961 that was quickly corrected the following year and (2) in 1987, sales data from both the Minneapolis and St. Paul Area Associations of REALTORS® MLS' were compiled into one common regional database, thus lowering the average of what had previously only been reported for the Minneapolis area.

Since the National Association of REALTORS® (NAR) began tracking sales data in 1968, there has never been a national sales price decrease.

Housing is inherently different than other investment vehicles like the stock market that are prone to “bubble” activity – it is not an “apple to apple” comparison. Consumers purchase homes for

more than just financial returns; housing provides shelter, warmth, community and a place to have life experiences.

Buying and selling a home is far more time-consuming, disruptive and costly than investing in the stock market. These constraints discourage large scale speculative buying and panic selling associated with a bubble burst. While there likely is a degree of speculative activity occurring in various real estate markets throughout the country – including the Twin Cities – the complexity of buying and selling a home greatly decreases the chance that such activity could become so widespread as to cause a dramatic price decrease in the future.

### **Housing and the local economy**

First and foremost, housing markets are a local phenomenon. Buyer and seller activity and price appreciation are directly affected by local economic and social conditions.

Fortunately, Twin City residents enjoy a high quality of life, a robust and diverse local economy, a skilled and creative workforce, and relatively ample employment opportunities – all of which have driven and will continue to sustain the healthy housing market the region has always enjoyed. The following trends will promote growing housing prices over the next several years:

- The regional population continues to grow at a rapid rate. Since the turn of the decade, approximately 37,000 people per year have moved into the 13-county MSA region – the equivalent of one suburban-sized community per year (U.S. Census Bureau).
- By 2030 it is estimated that the Twin Cities will have grown from three million to more than four million residents, all of whom need housing and many of whom will become homeowners (Metropolitan Council).
- New people are moving here from throughout the state, throughout the country and from all over the world. These are people who need housing, will contribute positively to an active real estate market, and will use REALTORS® to assist them in the process.
- The region has a strong corporate base, including fifteen Fortune 500 companies, other Fortune 500 size privately held firms, and thousands of mid and small size companies.
- Workers are highly skilled – 40% of Twin City residents hold bachelor degrees as of 2000. This ranks third among the nation's largest metro areas (U.S. Census Bureau).
- The Twin Cities' unemployment rate is consistently low and currently at a healthy 3.7% – down from 4.2% at this time last year. This ranks 4<sup>th</sup> among large metro areas and far below the national unemployment rate of 5.0% (Bureau of Labor Statistics).
- The median wage in the Twin Cities is \$16.83 per hour, ranking 8<sup>th</sup> among the nation's largest metro areas. Adjusting for regional cost of living differences, the region ranks 5<sup>th</sup> (Metropolitan Council Regional Indicators).
- The median priced home in the Twin Cities is \$231,000, ranking 11<sup>th</sup> among the nation's largest metro areas (NAR).

In a recent Channel 5 news story, Toby Madden, Economist for the Minneapolis Federal Reserve Bank, indicated the regional economy is strong (thus resistant to a housing bubble burst). Madden stated, "We have lots of jobs, very low unemployment rates, good income, and lots of wealth."

### **What causes a housing bubble burst?**

According to the economists at NAR, there are several elements that need to work in conjunction at the right time to create a rapid home price decrease or bubble burst:

- Strong price appreciation prior to the decline
- A significant local economic recession
- Local job losses lasting several years
- A sharp rise in housing inventory

- Speculators leaving the market quickly

### **The strength of the local housing market**

Examining the Twin City real estate market using NARs bubble criteria:

- *Strong price appreciation prior to the decline* – Yes, regional median housing prices have risen substantially in recent years. However, due to a healthy growth in housing inventory, the pace of appreciation has gradually declined over the past four years from a high of 11.9 percent to a current annual rate in the 6 percent range.
- *A significant local economic recession* – Extremely unlikely considering the Twin Cities' strong economic vitality and diversity, along with the skilled and creative workforce mentioned earlier. All signs point to a gradual and sustainable growth in the local and national economy in the coming years.
- *Local job losses lasting several years* – While threats exist in some sectors, any losses are expected to be offset by gains in other areas. It is highly unlikely the Twin Cities will experience prolonged job losses lasting several years.
- *A sharp rise in housing inventory* – While there has been a rise in housing inventory in the past year; it has been a gradual market shift from a seller's market towards a healthier balance of buyers and sellers. From 2000 into 2003, the market favored sellers to an unsustainable degree. This housing inventory shortage was the foremost catalyst for the rapid growth in home price appreciation during the first part of this decade. As predicted, the market has slowly corrected itself and achieved a healthy supply-demand balance.
- *Speculators leaving the market quickly* – Also an unlikely scenario. While speculative activity is occurring in some segments of the regional housing market, it is not to the degree that would lead to a housing bubble burst. What we do know is that the pace of development is at best keeping pace with our growing population. In addition, the regional market has demonstrated a long history of owner-occupied housing – the Twin Cities 2004 Homeownership rate of 73.9% ranks sixth among the nation's largest metro areas (U.S. Census Bureau). Recent NAR surveys indicate that only 3 percent of all homebuyers sell their home within a year or less of purchasing it.

There is persuasive evidence that the long-term regional real estate market should remain strong into the future, including continued price growth of at least modest levels.

### **“Risky” mortgages**

Some concern has emerged in recent months about the growth of “risky” mortgage products; adjustable rate loans, negative amortization loans, no-money-down loans and interest-only loans. Some postulate that an over-reliance on this type of lending could aid in a housing bubble burst if consumers become burdened with debt for which they are not prepared.

When placed in a historical perspective, “risky” loan originations in recent years are not astonishingly high. Loan-to-Value Ratio (LTV) is a good indicator of risk in mortgage lending. The higher the LTV, the more money is borrowed, the more risk the mortgage holds. According to the Federal Housing Finance Board, in recent years LTV ratios have been quite low as compared to years previous. While 2004 saw a slight increase in LTV from the previous year, both the nation and the Twin Cities' LTV Ratios were at their lowest levels since 1991 – the first year of several throughout the 90s with consistently high LTV Ratios.

The increased use of Adjustable Rate Mortgages (ARM) in recent years has also been raised as a bubble concern. While the use of ARMs has risen in the past several years from all time lows in the late 90s – particularly in the Twin Cities – the prevalence of this loan type in 2004 was within historical norms. In 2004, 47 percent of loans originated in the Twin Cities were adjustable rate – compared to 35 percent for the nation. For a few years during the 80s, between 50 and 60 percent of loans originated were adjustable rate at the national level.

While the mortgage market has seen a rise recently in loan originations that involve more risk than a “traditional” loan, the increase is not unprecedented. Several times in recent decades riskier borrowing activity has occurred without resulting in a decline in home prices.

### **What about the cost of money?**

Significant increases in the cost of financing will have an impact on the housing market but unless they are extreme in nature, they will not result in a regional bubble burst. As a case in point, in the early 1980s, when interest rates shot up to 17 percent, home prices did not decline. A more modest rate increase should only serve to decelerate the pace of Twin City home price appreciation to a more moderate level of low to mid single digits, say 2-6 percent.

### **What this all means for you**

Long-term interest rates look very favorable according to NAR and David Lereah, NAR’s Chief Economist believes home prices will continue to rise, citing the following factors:

- “The simple fact is we still have more buyers than sellers in most of the country,” says Lereah. “This supply-demand imbalance is continuing to put pressure on home prices, but we should get closer to equilibrium by the end of the year.”
- Boomers, retirees, boomer kids who are first-time homebuyers, and an influx of new immigrants buying homes will help keep the real estate market solid. “These demographic factors all combine for great support for demand for homebuyers going forward,” adds Lereah.
- Compared to the ho-hum stock market, real estate is still a good place to invest your money. Says Lereah, “This is also increasing demand for homebuyers and should continue for the rest of the year.”

Any investment includes risk, including real estate. The constant evolution of numerous events and factors massage all investment opportunities in ways both good and bad. However, evidence strongly suggests the Minneapolis–St. Paul regional housing market is robust, sustainable and on track for continued long-term growth, with home price appreciation expected to settle comfortably in the 4-6 percent range.