2006-2010 Forecast

California Real Estate Market Forecast

Presented by
The Mackey Sales Team

Prudential California Realty

Contents

This report focuses on statistics and examples of San Diego County, but the reader should know that Los Angeles and San Francisco are beginning to feel what San Diego has already experienced.

Introduction

Do you believe housing prices will continue to rise?   If you answered yes, you're not alone. There is a mass denial of the painful truth in the media, politics, and professional associations reporting daily that 'all is ok' and 'this time is different than last time'.

This time IS different. This time could be much worse than last time.

In light of all the hype and speculation about the local and national real estate market, we felt it our responsibility to take a stand and clear things up. In early 2005 our team began a comprehensive search that resulted in some strong and controversial conclusions.

By reading many books, attending multiple seminars, interviewing investors and 'declining market' veterans, then taking all that information, comparing it to the historic events, and to what we actually witness in the marketplace today, we were able to identify what seems to be an inevitable downturn of the California real estate market.

It is our belief that California real estate prices, which have already started to creep downward, will continue to fall until around 2010. This report will document WHY this is happening.

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The purpose of this market forecast is NOT to frighten you into selling everything! It is intended to be a 'reality check' to those that believe markets have no tops, or that the market will 'just level off for a little while'.

Our opinion is based on market information from many reputable sources. However, we encourage you to do your own research!
Confirm and verify what we say, then make rational decisions based on your individual circumstances, armed with the knowledge that a downturn is coming.

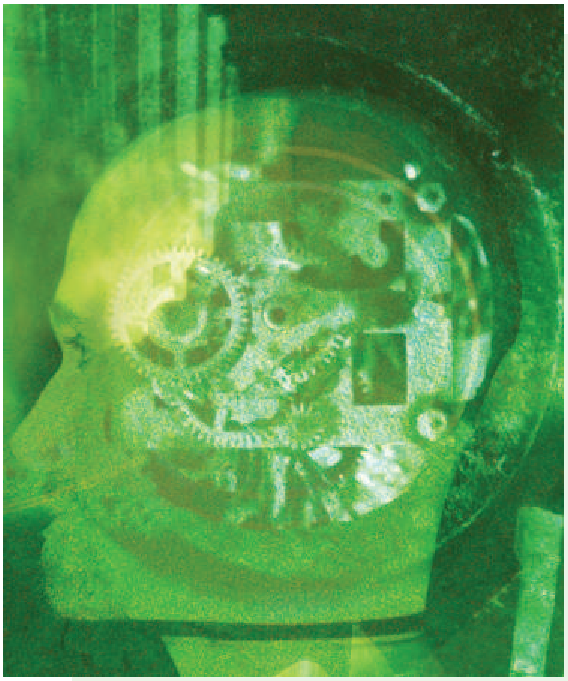
So let's take a look at the factors that will contribute to the upcoming downturn.

Market Behavior

The unparalleled success of the real estate market here is largely due to the emotional buying pattern of people wanting to live and invest in California. This euphoric mood causes normally price-sensitive, reasonable consumers to be willing to contribute a much larger percentage of their budget to home ownership.

Historically, Californians typically spend four to five times their median incomes for their homes. In the latest up-ward cycle from 1997 to 2005, euphoria, cheap money, and lenient lending practices have caused this multiple to climb from a customary 4.2 to an unprecedented 9.4 times the median income! It only makes sense that once the euphoric mood is over, California real estate prices will return to a more normal multiple of income.

To suggest there will not be a down cycle would be to say the fundamentals of human nature do not apply to California. The famous Wall Street analyst, Charlie Dow, showed that markets move in cycles, and that these cycles have specific "Market Phases" and "Psychological Phases":



The Psychological Phases of the Market

Up Market (Bull Market)
1984-1989 and 1998 – 2005
First – Disbelief
Later - Rising Expectations
Finally - Mindless Euphoria (Spring 2005)

Down Market (Bear Market)
1990-1997 and 2006 - 2010
At First – Disbelief (Occuring now)
Later– Despair (Must sell at a loss)
Finally – Resignation ('Just get rid of it!')

Affordability

Housing Affordability is an index that measures the percentage of households that can afford to purchase a median-priced home in California. Contrary to the impression given by the media, higher affordability does not mean the housing market is doing well. The opposite is actually true: the higher affordability is, the less demand there is on real estate, thus, the lower the prices. On the other hand, declining affordability accompanies “hot markets” and escalating prices. But the housing affordability cannot decline forever.

Historically, California has a problem when annual affordability index reaches 17%. Such low number has only been reached two other times, in 1980 and in 1990. The significance of this number is that it marks the point at which the buyers are still very much eager to buy, but can no longer qualify for the payment, causing the market to slow. This, in turn, sets off a predictable and inevitable sequence of events leading to a market decline.

According to the California Association of Realtors (C.A.R.), the monthly Housing Affordability Index in California stood at 14% as of the December 2005 monthly report.

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Interest Rates

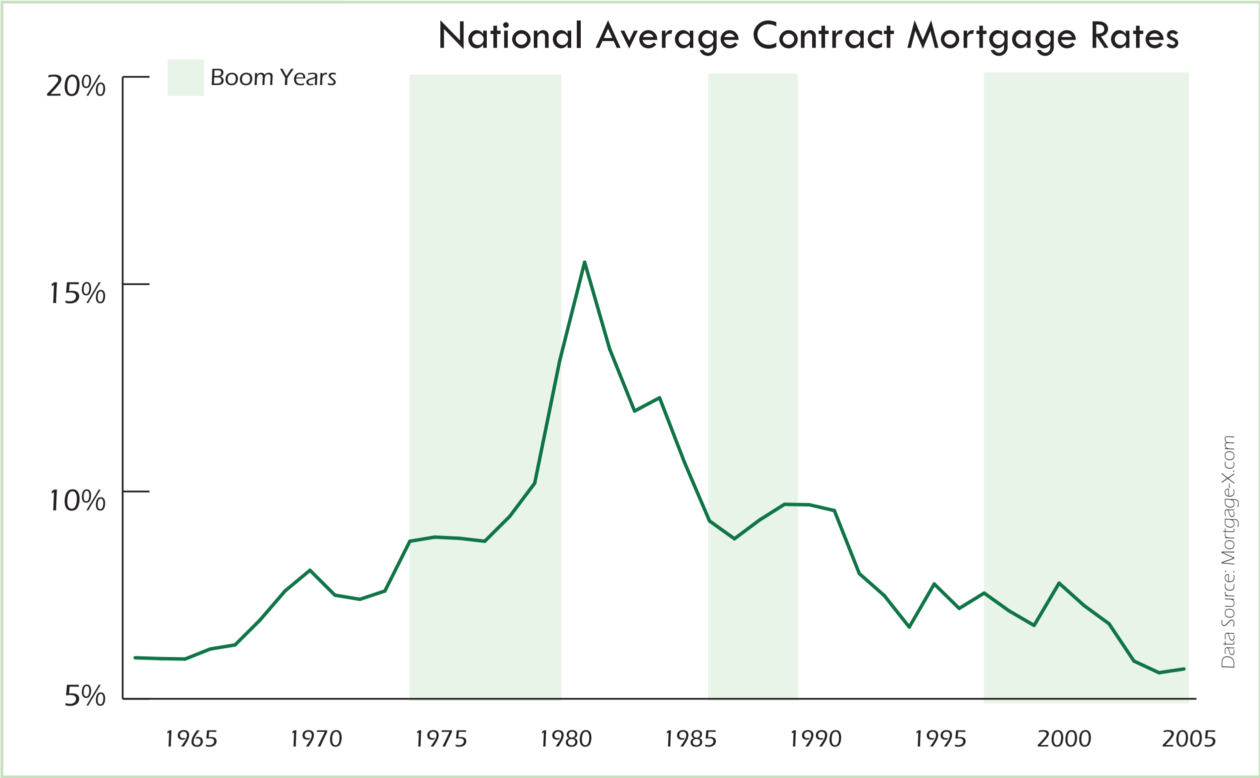
We have cornered ourselves into an all-time low affordability on interest rates alone.

It is a popular belief that the lower interest rates are, the better the real estate market does. This simply isn't the case. As shown below, the well-known California "down markets" of 1981-1985 and 1990-1996 occurred while interest rates declined. On the other hand, during "boom years" of 1974-1980, 1988-1989, and 1999-2000 the rates went up.

While interest rates have never been the only factor in California's Boom and Bust cycles in the past, for the first time in history we have cornered ourselves into an all-time low affordability on interest rates alone. There simply is no place to move.

So, then, the question is this: Do you believe the interest rates will remain the same, go down, or go up?

With a simple review of recent economic news and past trends, it is easy to conclude the mortgage rates (30-year mortgage rates are tied to the 10-year T-bill rates) are most likely to increase in the upcoming months and years.



Construction

“Within two years of reaching 17% affordability, builders had an increase of unsold houses by 1,000%”

The Anderson School of Economics at UCLA forecasts that a recession in California is likely by 2008, led by a decline in construction. There are already many indicators that this forecast will prove true.

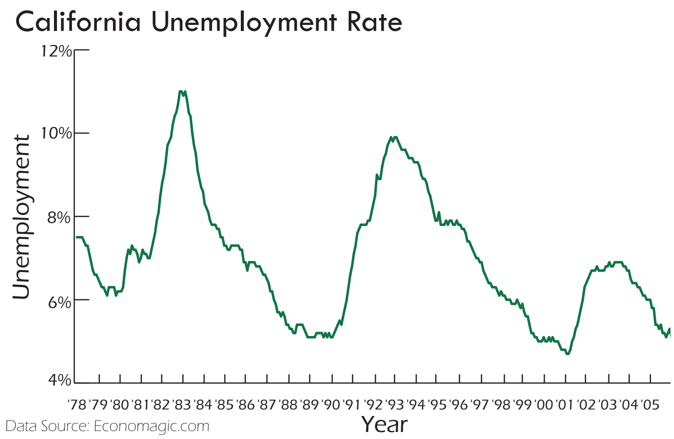
New housing permits issued for single family units fell 18% statewide and 28.8% in the San Diego Metropolitan Area between November 2004 and November 2005, according to a report by the Construction Industry Research Board. This is one of the first and most important trends to follow in the overall market decline scenario.

Why is this happening? One of the reasons is that builders are now having trouble selling their inventory. In one of his recent quarterly newsletters renowned real estate investor, author and educator Bruce Norris wrote about the trend.

“Between June of 2004 and June of 2005, unsold houses in Southern California have gone up 300%. The exact numbers are: 1973 unsold in 2004, 6118 in 2005,” he says. “The numbers aren’t high, but the trend is unmistakable. This is exactly what happened last time. Within two years of reaching 17 % affordability, builders had an increase of unsold houses by 1,000%”.

What effect does this have on the housing and job market? Read on.

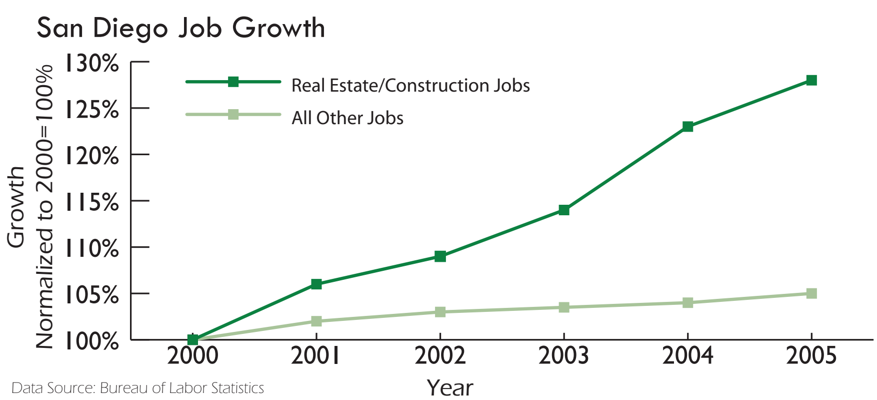
Jobs



Historically, the last two times California's affordability index reached 17%, construction decreased between 40% to 60%. Every time that happened unemployment rates nearly doubled.

When the builders can no longer sell their inventory, they are not eager to build more houses. The less they build, the more people they lay off. The laid-off workers then pack up, gather their families, and leave California.

It is not hard to imagine what a 40% to 60% decline in construction will do to employment. And because a decline in construction will inevitably trigger a slowdown in existing home sales, it, in turn will cause a massive job loss in industries related to real estate. Along with all the real estate sales jobs (agents, brokers, and their staff) and servicing jobs (title, escrow, home inspection, etc.), this also includes the lending business and anything associated with refinances – a monster industry of its own.



This could be devastating to a region that depends on these industries. The Anderson School of Economics at UCLA estimates that 40% of recent job growth in the state has been directly related to the super-heated real estate activity. Regrettably, a slowdown in this area will have a significant impact on California's employment and aggregate income.

To add insult to injury, with construction and re-sale slowdown homeowners will soon run out of home equity to pull out. This will wipe out the "wealth effect"-related stimulus that California has enjoyed for the past several years, thus causing the retail sector jobs to suffer as well. A decline in retail spending will subsequently impact commercial real estate, perpetuating the downward cycle.

Once again, what do people do when their jobs disappear? They leave.

Migration

An article in the July 2005 issue of *California Real Estate Magazine* detailed how Californians are increasingly moving away.

"With C.A.R.'s housing affordability index at a near record low of 17 percent, many Californians appear ready to throw in the towel on the dream of owning a home," wrote Michelle Hofmann in the magazine. "In fact, a growing segment of buyers is looking across state lines in search of a place to call home."

Hofmann went on to describe the numbers.

"California's state-to-state migration rose 18 percent in 2002 and reached 29 percent in 2004," she wrote, citing a survey done by the C.A.R. "California topped the list of outbound regions in 2004 with almost 56 percent of households headed out of state, according to the 37th Annual Allied Van Lines Magnet States Report, which tracks national migration patterns. And relocation companies say the dubious honor marks the fourth consecutive year in which outbound stats for the Golden State exceeded inbound moves and denotes the region's highest out-migration in nine years."

Add to this a very much predictable real estate and construction related job loss, and you get the picture. Unquestionably, this will have a further significant negative impact on real estate demand and will perpetuate already declining prices.

Californians are increasingly moving away—California topped the list of outbound regions in 2004.

Foreclosure

“The impact of a huge increase in foreclosures will be felt by virtually every property owner in California.”

Today, the finances of many homeowners are stretched to the max. For many, there’s practically no room in their budgets to suck up higher gas prices, cost of travel etc. As the housing market “cools off” and prices decline, the tapping into property equity will stop, and that disposable income will no longer be there to cushion families against their over-exuberant spending of the recent years.

And what’s worse, is that there are so many owners now holding extremely “high risk” interest-only or negative amortization ARMs. Statistics show that a majority of all transactions in 2004 and 2005 were adjustable or interest-only loans, with many home owners doing cash-out re-financing every year. Lenders tell us that most of these loans were also “no-doc”, “stated income” loans, with appraised values jacked-up by the “refinance boom” happy appraisers.

What this means is we have a whole lot of folks maxed out on their equities, while holding loans with unstable interest rates. For many, the upcoming scheduled change in the loan repayment structure would mean their monthly payment will almost double when the “teaser” rates adjust. Ouch! Most have no additional income to handle this.

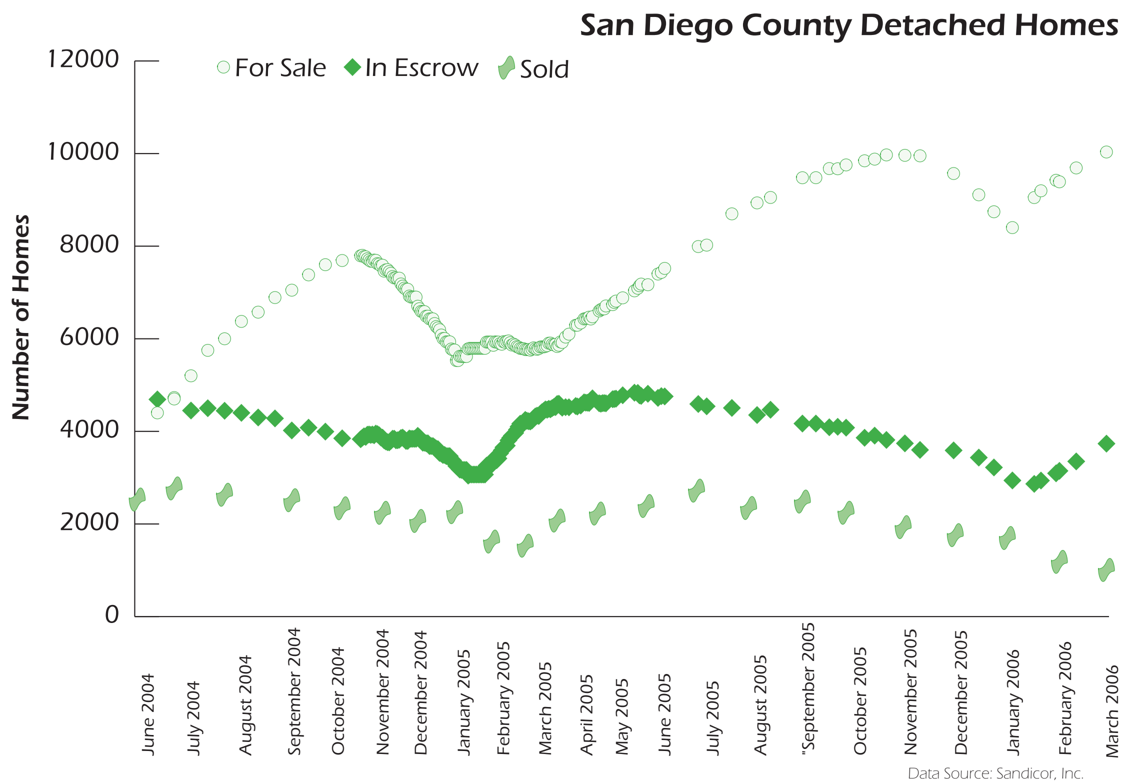
What can they do? Refinance into another adjustable loan? Not a viable option in most cases, since a re-appraisal will be required. If the property value has declined, such appraisal will only prompt the lender to ask the borrower to bring down the principal loan balance (by writing a check, of course!).Will the owner write the check? An unlikely scenario, considering the owner is struggling to make the scheduled payment in the first place. With loan balance equal or exceeding property’s value, a sale will not bring a relief either.

Can you say FORECLOSURE? And as we well know, foreclosures not only create more and more competition and inventory in the market, they negatively impact the “human factor” of the marketplace, making real estate to be perceived as “undesirable,” a burden, something nobody wants.

“This is a very important subject,” writes Bruce Norris in his California Countdown course. “The impact of a huge increase in foreclosures will be felt by virtually every property owner in California. Even if you aren’t the person in foreclosure, the value of your property will be impacted by the properties taken back by the bank.”

And so the spiral continues.

Conclusion



In January 2005 we had about 9,000 homes for sale in San Diego County (combined total of single-family and condominium). Since then inventory has climbed to almost 17,000 homes. The time it takes to sell a home has increased from 36 days in 2004 to about 67 days in February 2006. The volume of sales has been decreasing since 2004 with a small 2% decrease over 2003, a 7% decrease between 2004 and 2005 and what appears from the month to month statistics to be a 20% to 40% decrease in sales for 2006.

A thorough review of California historic market trends and application of simple logic demonstrate that the market has changed, and will continue to change considerably over the next few years.

We wish it wasn't so, but we hold it as our firm belief that real estate prices in California will decrease through 2010. This opinion is rooted in lengthy and extensive research and analysis. At this time, the evidence supporting our conclusion is undeniable.

Nevertheless, PLEASE do your own research! Scrutinize and verify everything said here! Allow logic and wisdom to rule the conclusions you make. Then ask yourself what a 20% to 30% decrease in the value of your home or investment would mean to you. Please use this information to plan accordingly, and make your decisions based on the facts, rather than the numerous speculations floating out there today.

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Mackey Sales Team
12544 High Bluff Drive #100
San Diego, CA 92130
Ph: 800.993.2254
Fax: 619.374.7478
www.*MoveSanDiego*.com

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Contact us with specific needs or questions at 800.993.2254.

The Mackey Sales Team is dedicated to serving all the Real Estate needs of Sellers, Buyers and Investors.

To know more about where California's real estate market has been, where it is going, and what strategies to employ, see our California Investor System at www.CaliforniaInvestor.com for a comprehensive presentation and analysis.

Resources

The Norris Group:www.thenorrisgroup.com

California Building Industry Association: www.cbia.org

Bureau of Labor Statistics: www.bls.gov

Economagic: www.economagic.com

Voice of San Diego: www.voiceofsandiego.org

Data Quick Real Estate News: www.dqnews.com

Builder Online - Information Source for the Home Building Industry: www.builderonline.com