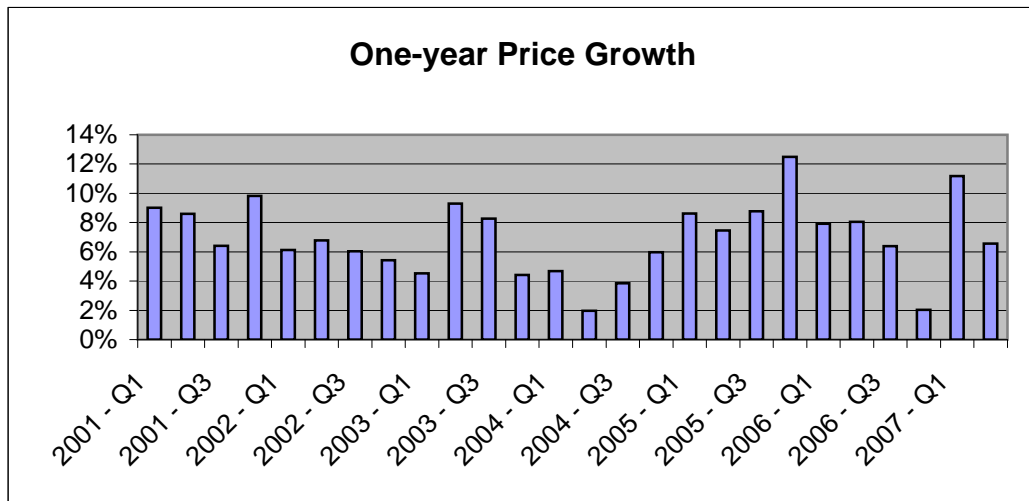


## Price Analysis for the San Antonio Region

October 2007

Home prices in the San Antonio Metro Region rose 6.6% in the second quarter of 2007 - slightly slower than the 9% appreciation during 2005. A rise in mortgage rates in early 2006 will no doubt cause some shift in the market in favor of buyers. Home sales have so far held their ground but inventories have been rising. Investors, who had artificially raised demand in 2004 and 2005, are evidently now dumping the properties on the market. Also, subprime loans that are now resetting have burdened some recent homeowners who have yet to accumulate equity.



Despite the negative factors, home prices still remain positive. This is because unlike past local housing downturns, which were accompanied with severe job cuts, the local economy continues to add jobs. Furthermore, apartment rents nationally have been rising at the highest pace in 5 years, which will begin to encourage some renters to seriously consider ownership. Mortgage rates have also been falling recently and stood at near historic lows with a rate of 6.5% for prime borrowers. Rates could be even more favorable in upcoming months as the Federal Reserve cuts the Fed funds rate in late 2007 and in 2008 as there are clear signs of contained inflation. A revival in FHA loans, which had lost significant market share to the risky subprime market, will provide funding for moderate income households - at much more attractive mortgage rates. In addition, it is worth noting that homeowners who had purchased a home in 2004 or earlier have sizable housing equity gains and are in little danger of facing foreclosure. For example, a typical homeowner in this market who bought three years ago would have accumulated \$29,600 in housing equity.

The outlook is positive. Homebuilders having drastically cut production which will help minimize any prolonged oversupply conditions. Further production cuts by the builders will better help the market to quickly return to a healthy state. On the demand side, job gains have added to the number of potential homebuyers. The historical relationship implies roughly one additional homeowner for every two new jobs. Since the peak of the housing market two years ago, the local market added 46,700 net new jobs (July 2007 vs. July 2005). An increase in home sales and strengthening of home prices appears a certainty, in time.

**Summary of Activity**

	<b>San Antonio</b>	<b>U.S. Average</b>
<b>Price Activity</b>		
1-year Appreciation (2007 Q2)	6.6%	-1.1%
3-year Appreciation (2007 Q2)	23.7%	15.4%
3-year Housing Equity Gain	\$29,600	\$29,900
<b>Affordability</b>		
Current Mortgage Servicing Cost to Income	13%	22%
Historical Local Average	18%	22%
<b>Home Sales and Mortgages</b>		
State Existing Home Sales (2007 Q2)	-1.3%	-10.8%
* Single-Family Housing Permits (2007 July)	-26.9%	-29.5%
Share of Second Home Loans (2005)	15.4%	15.0%
Rise in Second Home Loans (2000 to 2005)	327%	215%
**Share of High-Interest Rate Loans (2005)	26%	28%
State Foreclosure Rate (2007 Q2)	1.2%	1.4%
State Prime Loan Foreclosure Rate (2007 Q2)	0.5%	0.6%
State Subprime Foreclosure rate (2007 Q2)	4.1%	5.5%
<b>Local Fundamentals</b>		
1-year Job Additions (2007 July)	16,200	Not Comparable
3-year Job Additions (2007 July)	67,900	Not Comparable
1-year Job Growth Rate	2.0%	1.4%
3-year Job Growth Rate	8.9%	5.0%
1-year Job Gain to New Single-Family Homes	1.4	1.5
3-year Job Gain to New Single-Family Homes	1.7	1.7

\*Rolling 12-month sum vs. a year ago

\*\* Based on HMDA data which indicated 3% point higher interest rate loan above the market rate

**Price Forecast Scenarios**

The home price forecast in the San Antonio area varies based on alternative assumptions regarding mortgage rates and the sustainability of mortgage debt levels. Prices are expected to climb 6.3% in 2008 (Path 1) if mortgage rates remain relatively stable at around 6.5% over the next two years. The bulk of the price increase comes from the rise in income (assumed to rise at the same pace as in 2006) while mortgage rates remain stable. The current mortgage debt servicing capacity, though higher than normal, could indeed be sustainable given the sustained job growth and constrained housing construction in the area.

If debt servicing capacity is not sustainable and returns to its 2004 level (the year before the housing peak in 2005) then prices are expected to rise more modestly (Path 2). The next two scenarios show outcomes based on whether mortgage rates turn favorable or unfavorable in relation to the baseline assumptions. Prices would decline 4.5% if mortgage rates were to rise to 7.5% next year from the current 6.5%. However, with the Federal Reserve ready to cut the Fed funds rates, it is difficult to foresee such a rise in mortgage rates.

**Alternative Price Forecasts**

	<b>Mortgage Rate in 2007</b>	<b>Mortgage Rate in 2008</b>	<b>Debt Service Capacity*</b>	<b>Comment</b>	<b>Price Growth in 2008</b>
<b>Path 1</b>	6.5%	6.4%	12.6%	2006 debt levels were higher than normal, but can be sustained due to job gains and housing shortage	6.3%
<b>Path 2</b>	6.5%	6.4%	11.3%	Debt level returns to the 2004 level (pre-boom year) by 2010 in steady steps	3.5%
<b>Path 3</b>	5.2%	6.0%	11.3%	Same as above but at more attractive mortgage rates	6.9%
<b>Path 4</b>	5.2%	7.5%	11.3%	Same as above but at less attractive mortgage rates	-4.5%

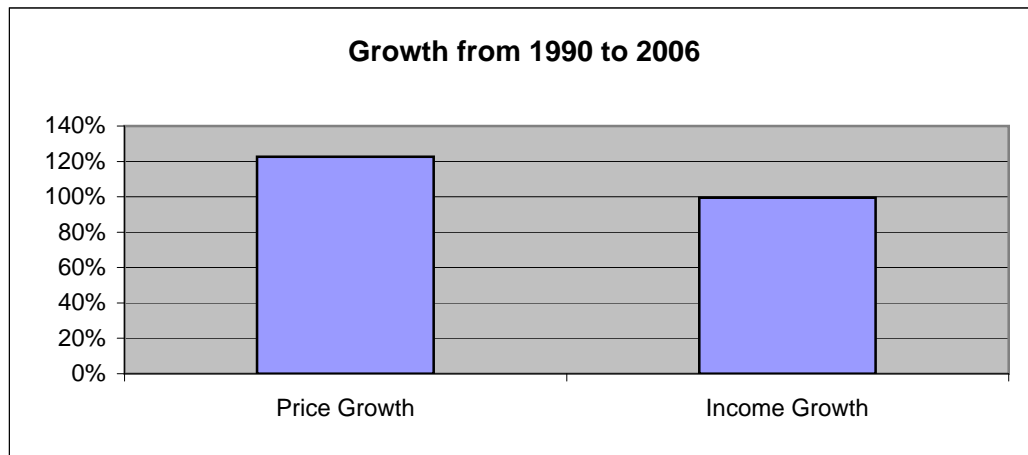
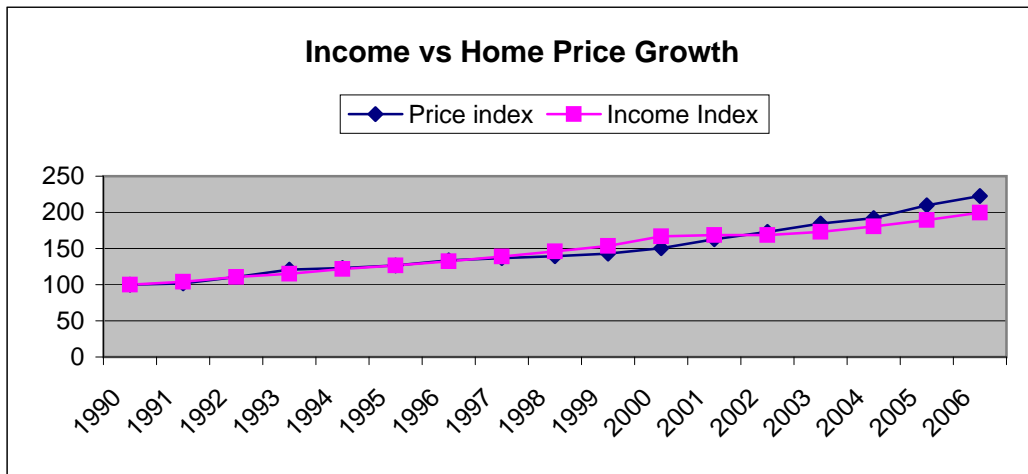
The above mortgage rate and economic forecasts are well within the range of credible Wall Street and government economic forecasts. As for mortgage debt, it is certainly conceivable that households were stretched to their maximum in 2006 - and now need to unwind. This would cause debt capacity to return to its 2004 level or even to the metro market's historical average over the next few years.

It is always a possibility, however small, that the economy could suddenly turn for the worse. Oil prices - assumed to remain at around \$70 per barrel for most of the next two years - are always a wild card. A further weakening of the dollar or changes in foreigners' appetite for holding dollar-backed assets, including mortgage-backed securities, could suddenly and measurably push interest rates much higher. Also, homebuyers' confidence could remain weak despite solid gains in jobs, income, and wealth. In such cases, home prices could weaken measurably from what is assumed in the above cases.

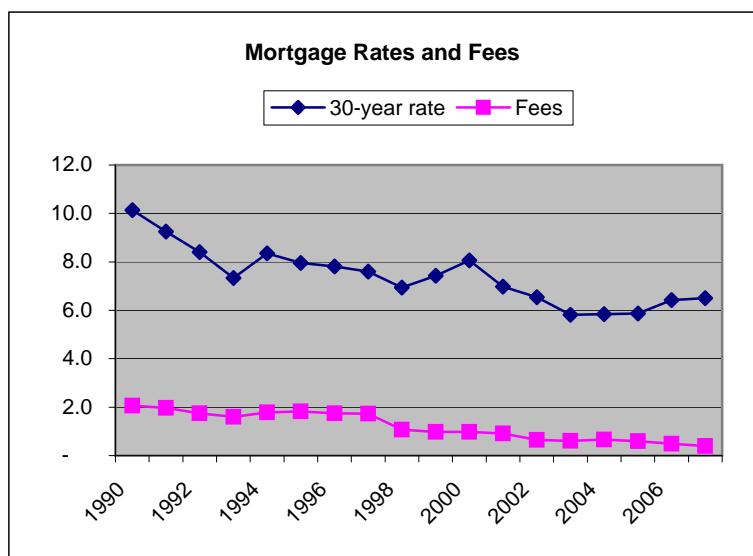
\* Debt capacity is the mortgage payment amount at the prevailing mortgage rate as a percentage of income. Income is assumed to rise at the same rate as in the most recent past year. It is based on 100% financing and does not include property tax and other homeownership costs. Because this definition is the same for all periods, what is relevant in the analysis is the relative position of the debt capacity and not its absolute level. That is, using 80% LTV financing would not have changed the price forecast.

### Price Activity

Many of the analysts who have called for a major housing market correction point to the disconnect between income growth and home price growth in recent years. This divergence developed in 2002, but remains small in comparison to many major metro areas.

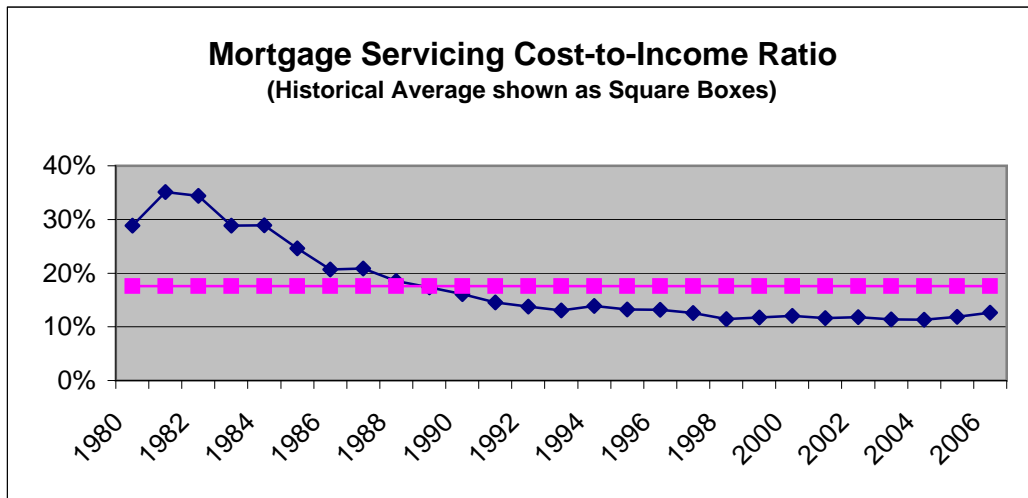
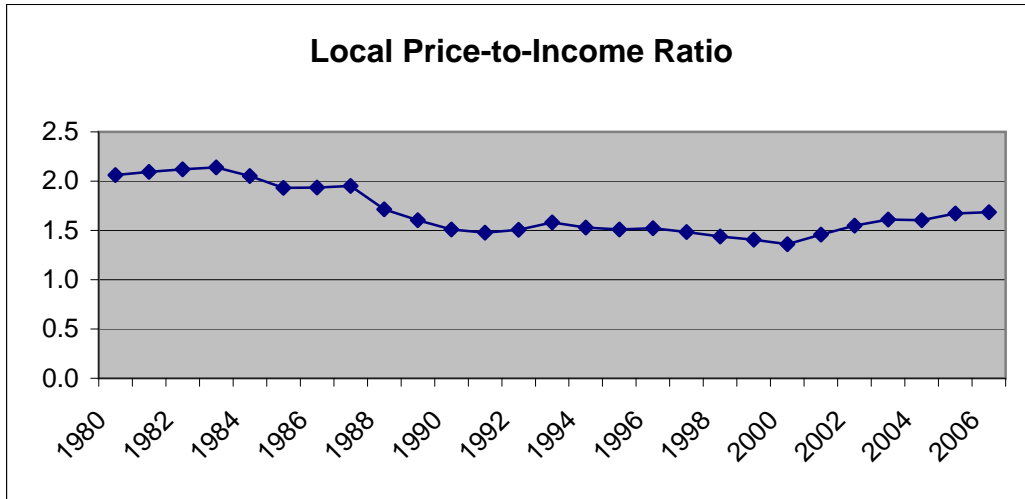


However, an analysis based solely on price and income growth is inappropriate. For a homebuyer, what is relevant is not home price in relation to income, but rather the mortgage payment in relation to income. Since 1990, interest rates have generally trended downward, thereby raising purchasing power with the same level of income. Furthermore, the fees associated with taking out a mortgage fell from about 2% to less than 0.5%. As such, any home price analysis needs to taken into account the lower overall mortgage borrowing costs.

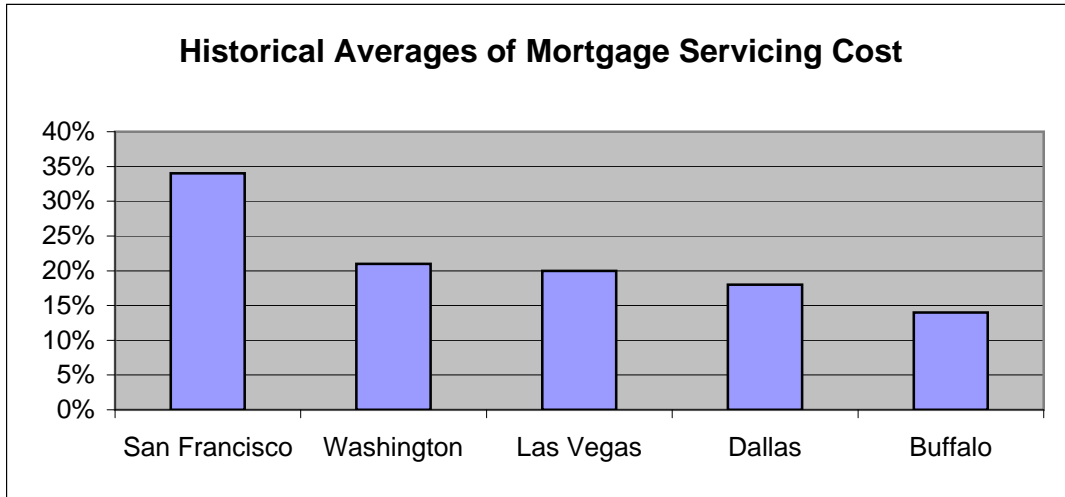


**Affordability**

A better factor for assessing the risk of a home price bubble is the median mortgage servicing cost relative to median income. As shown below, mortgage servicing costs fell significantly after 1990, reflecting better affordability than the price-to-income ratio suggests. Locally, the mortgage servicing cost is well below its historical average.



The key question for this local market is whether or not the current debt servicing cost can be sustained. Unlike many of the high priced markets on the East and West Coasts, the San Antonio metro area did not experience white hot price growth. Simultaneously, the local labor markets have done well, taking on jobs while wages and salaries have grown. As a result, conditions in much of the area continue to remain very affordable today.



Price differentials among local markets can exist for prolonged periods due to many factors (including those difficult to measure). Measurable factors like income, housing shortage, job growth, and foreclosures certainly play a role. But, intangible (non-measurable) factors like the quality of life, water views, city vibrancy or quietness, cultural amenities and zoning laws also impact home prices. San Antonio has benefited from the expansion of the three local military bases which have helped to boost the local economy. But the manufacturing and biomedical industries have also been on the rise. San Antonio is spread out over a large geographic area and restrictions on building are minimal both of which help to keep prices in check. While prices have risen, they've been compensated by falling mortgage rates and rising incomes.

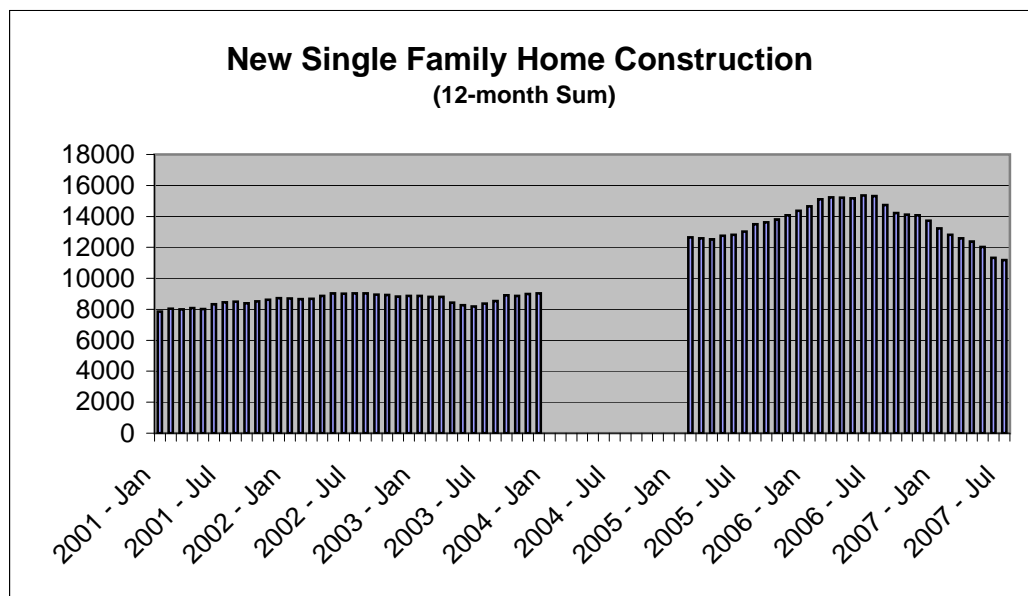
### Local Fundamentals

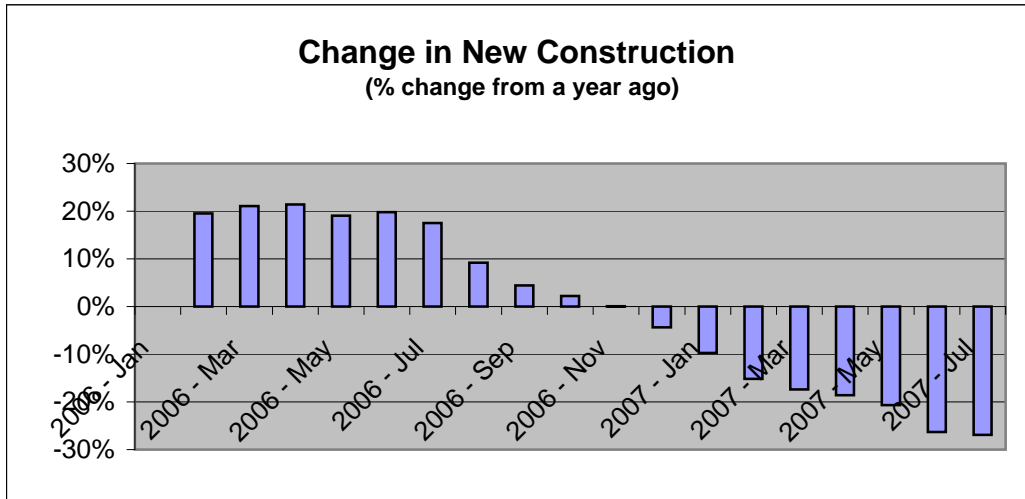
The local job market is very important in supporting housing demand. San Antonio's labor market is dominated by services that support the large, local military bases and the burgeoning bio-medical industry. At the same time, changes in housing supply can quickly upset the market balance. It is, therefore, critical to monitor the housing demand and housing supply factors to assess if the local market is trending to a tighter or looser condition.

Fortunately, job gains have continued. In the past 12 months, 16,200 payroll jobs were added to the local economy. In the past 3 years to July, 67,900 jobs have been added. Such job growth should provide underlying support for local housing demand.

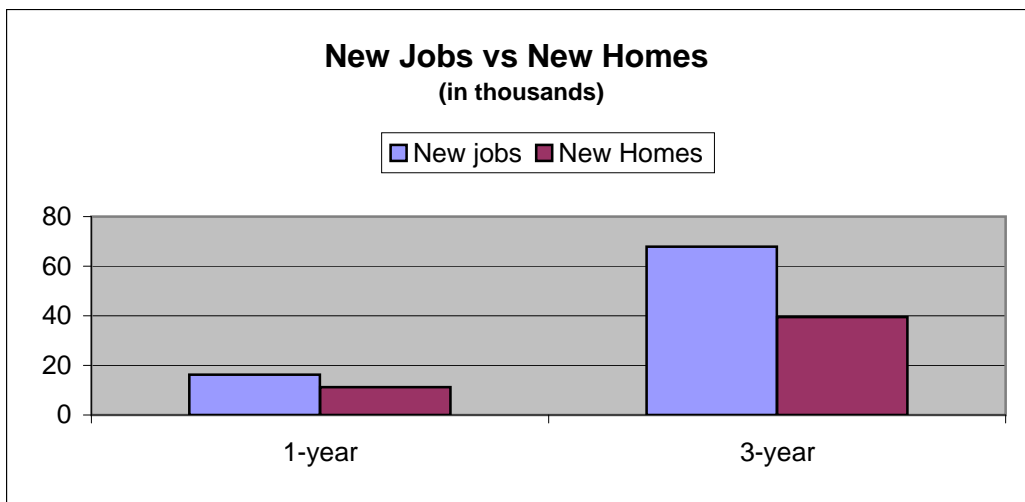


On the supply side, there has been a marked reduction in new home construction in the past year. A drop in new housing supply helps prevent prolonged oversupply conditions. The 11,182 new single-family home additions in the past 12 months is far lower than the job gains.



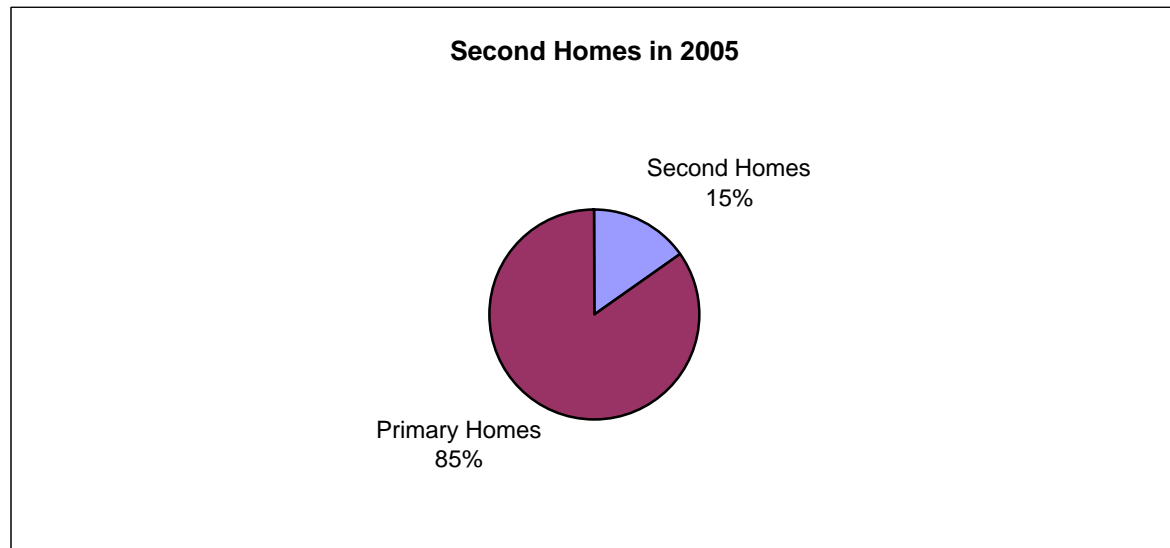
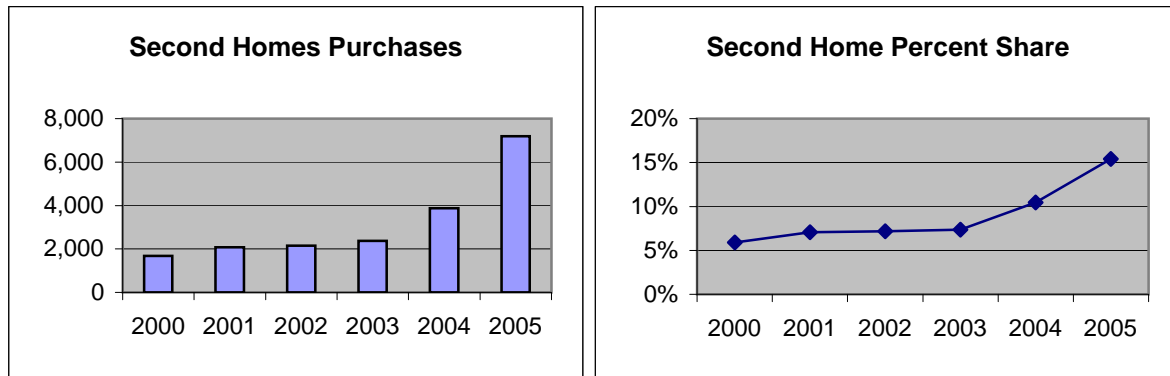


As can be seen above, focusing on construction activity after 2006 shows a recent trend towards supply reduction. As can be seen in the chart below, more jobs were added than new single-family homes were constructed in the past 12 months. The same is roughly true over the past 3-year time span. This pattern suggests that construction has increased to meet the strong demand for housing in the area. Increased home production will help to keep prices from growing out of control and sustain long-term demand.



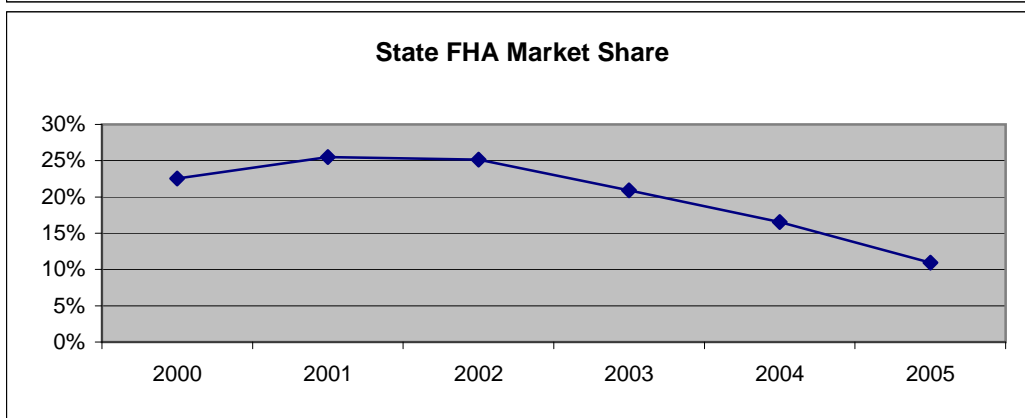
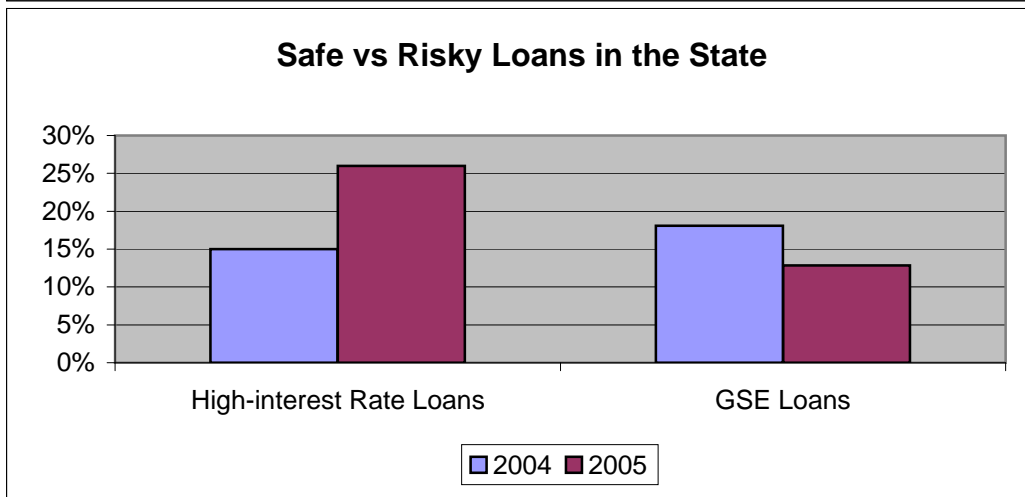
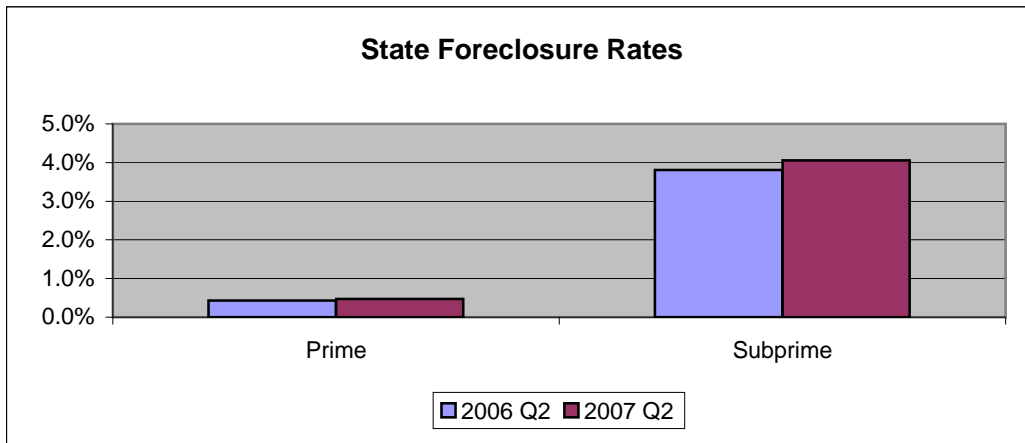
## Second Homes and Investor Demand

One area of weakness to consider is the short-term oversupply of existing homes on the market. The local market was fueled in part by second-home buying activity. Undoubtedly, the healthy local job gains brought speculators into the San Antonio metro area. Based upon mortgage data (HMDA), loans taken out for vacation and investment properties rose after 2003. However, the proportion of purchases that were for speculation in the San Antonio metro area was far below those of the booming markets on the coasts or the national average. As home prices moderate, though, investors unable to pay the mortgage carrying cost are evidently pulling out. As a result, to an extent, demand fell in 2006 and 2007, while the supply was being "artificially" elevated as investors put properties on the market.



### Mortgage Market Conditions

Foreclosure rates have been relatively stable for both the subprime and prime sectors. The Texas foreclosure rate is still slightly below the national average as listed in Page 2. However, the prevalence of high-interest rate loans (those at least 3 percentage points higher than the market rate) soared in 2005. The data for 2006 is not yet available but similar mortgage origination activity likely took place. The recent cleansing of bad lenders from the market will restrain home buying, but it will be good for the long-term health of the market. The market shares for GSE and FHA loans fell off recently, but they will rise as these products will regain their market share from subprime loans.



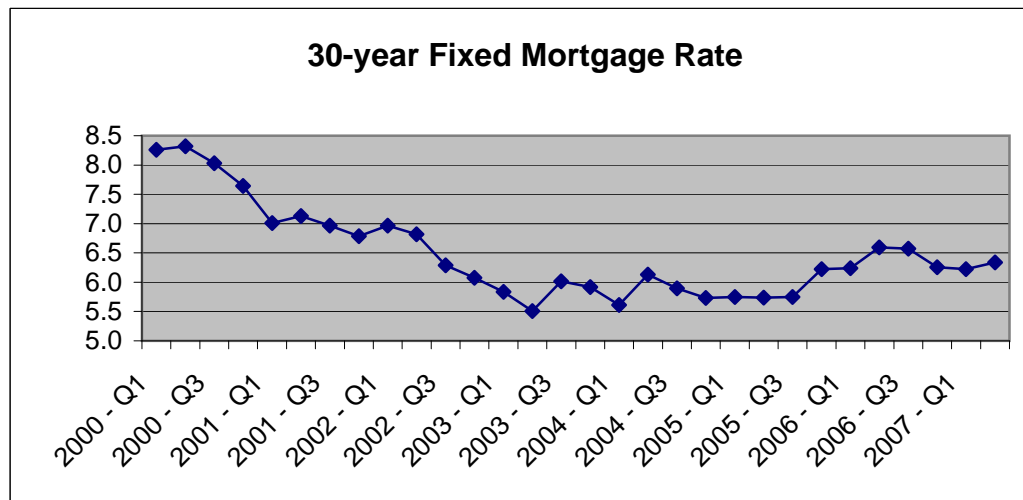
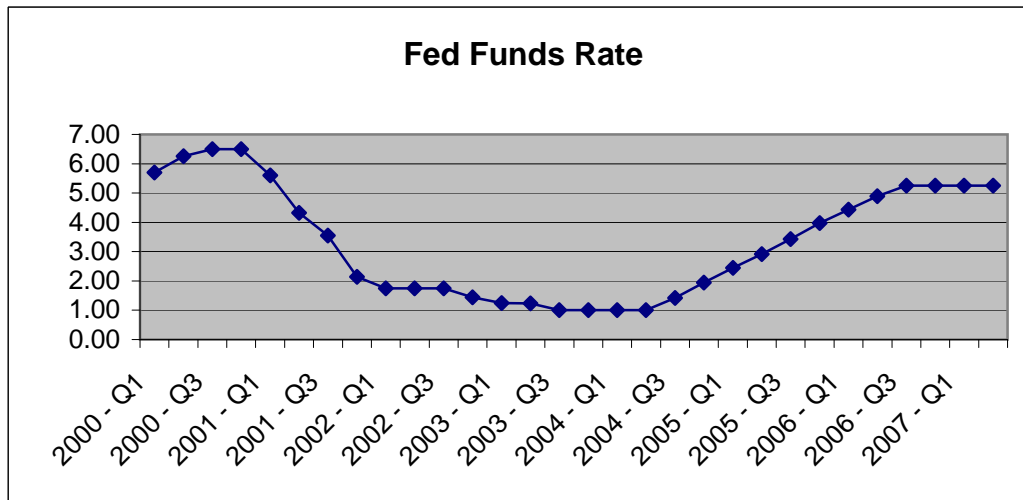
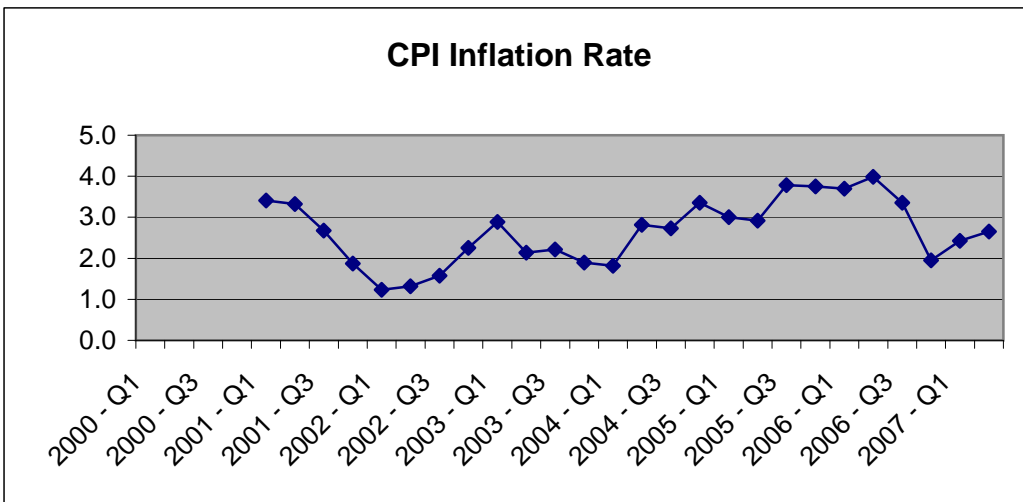
## Summary

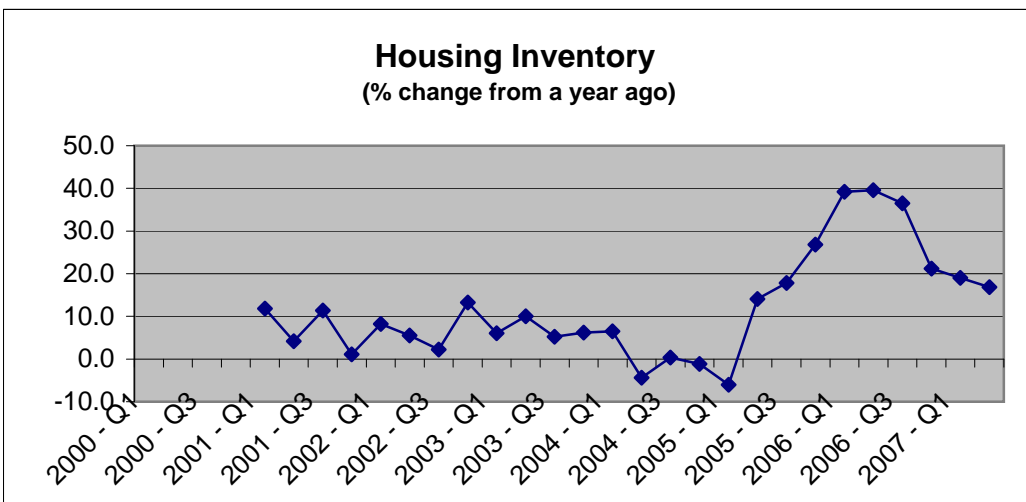
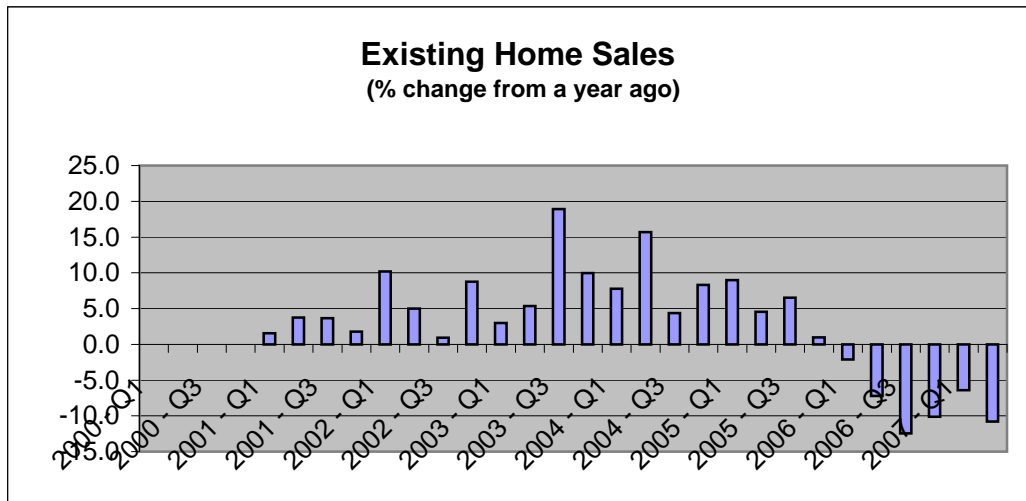
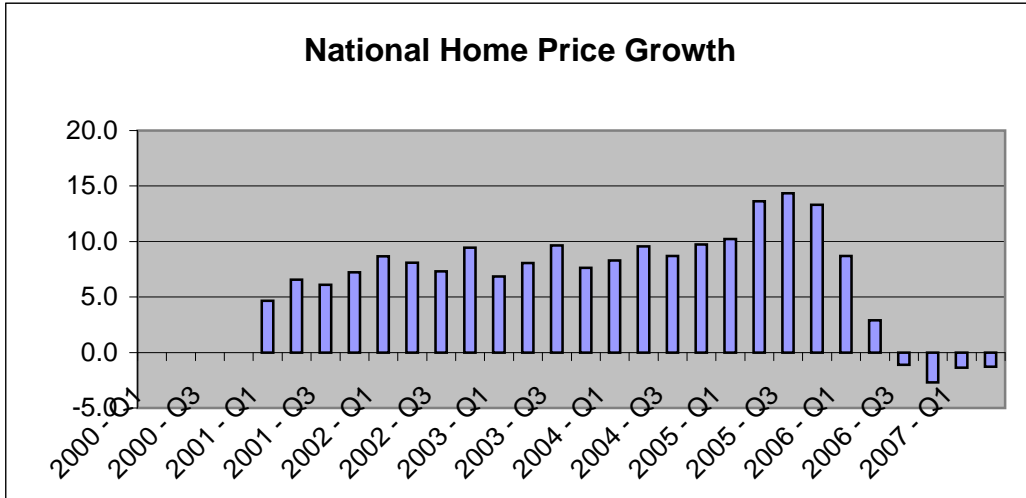
The San Antonio housing market is one of the better performing in the country, but it is likely to shift towards a buyer's market in the coming year. The key catalyst was rising mortgage rates in the first half of 2006. Home sales moderated somewhat as a result. But recent declines in mortgage rates have not led to more buyers - implying a confidence factor, or lack thereof, in the home buying decisions. The recent subprime fallout is a concern, though the shakeout is good for the long-term health of the housing market as bad mortgage lenders are eliminated. So far, the local economy has been performing respectably. It should continue to expand as the bio-medical industry continues to grow. In the aggregate, business spending and export growth will keep the U.S. economy out of recession despite some expected softening of consumer spending as housing wealth accumulation stalls.

Inflation appears to be contained. Both the headline and the core consumer price index decelerated to 2.4% and 2.2%, respectively, over the past 12 months. Better yet, most economists anticipate a further deceleration in inflation in 2007. Such an outcome could well lead the Federal Reserve to cut the federal funds and prime rates down the road. A federal funds rate cut is no guarantee of a fall in mortgage rates, but the signal that inflation is contained will force bond buyers to demand lower inflation premium, and hence, lead to lower mortgage rates as well.

With job additions continuing and mortgages rates hovering at about 6.4% as of early September 2007, the housing market is poised to slowly climb back. If, however, mortgage rates were to rise to 7% or higher, then the housing market would continue to limp along with the possibility that home prices and overall housing wealth could drop and, consequently, consumer spending could slow. Past economic cycles have shown that a prolonged housing weakness can measurably slow the economy, and in some cases move it into a recession. Let's hope such a higher interest rate scenario does not play out.

**Additional Informative Charts**







## **NAR Research**

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