Supply, Demand, Balance: How Do you Measure a Balanced Market?

This was the Poll Question posed in the Inland CA Appraisers Forum Yahoo Group that I created in February after speaking to a group of local appraisers in Palm Desert about Market Condition and Declining Value issues and ran into denial from many.

I have taken the Poll results, the first of its kind, and even though a small sample size, have combined the results with some current market data to address these issues that are confronting us as the markets constrict and in many cases, decline, all across America.

How do you measure a Balanced Market in a suburban market area? It is the Months worth of Supply divided by the last Month worth of Sales or the last 12-month worth of sales averaged.

How many Months worth of Inventory is a Balanced Market?

The poll is blind, no identities are revealed, only the results. If you know for certain and have ANY point of authority, share it with the group.

Here were the choices {the default was 12-15 months}:

- ○ 1-3 months
- ○ 4-6 months
- ○ 7-12 months
- ◉ 12-15 months
- ○ 15-18 months
- ○ 18-24 months
- ○ 24-30 months
- ○ 30-36 months

Here were the responses

Choices	Votes	%
1-3 months	**3**	**12**
4-6 months	**11**	**44**
7-12 months	**4**	**16**
12-15 months	**7**	**28**
15-18 months	**0**	**0**
18-24 months	**0**	**0**
24-30 months	**0**	**0**
30-36 months	**0**	**0**

Written by Steven R. Smith, MSREA, MAI, SRA, 8/31/06

OK, now that we have 25 responses, here is the scoop from my point of view, tempered by 30 years of watching the markets. I have used this and monitored numerous markets with it and it works. If you think there is merit in this topic, we can put together a seminar and get into case studies and multiple examples. Sound off on this issue to the local Chapter or to National.

Since 1982 I have monitored the markets we worked, starting by looking back to 1974 which was before the first real double digit run up in prices.

While our office once covered large geographic territories, giving Service to the clients, we retracted our market area by mid 1982 after we discovered fraud in the databases and issues requiring true geographic competency.

When we covered large areas, we had little time to think about what was going on in any one of them. We spent most of our time on the road. I had been trained by a S&L who expected three {3} appraisals per day, and I carried that mindset into the fee appraisal business.

It worked well in a rising market and got me in trouble once the market turned. If by reading this, one person is helped, my heart will sing with joy. You don’t have to get into trouble like I did before you change behavior that can and will be used against you.

At that time, I was in the San Fernando Valley. We worked the west Valley and the West-side of L.A. Our primary MLS boards were SFV and the Combined L.A./West-side and Malibu.

The SFV MLS had 20,000 members in 1979, the largest in the world even before all the mergers and regional boards were formed. The also had good statistics. By watching their monthly reports, and reviewing annual statistics back to 1974, we saw that a normal real estate market had an annual cycle to it. The peak months were from May through August, and then sales slowed each month through January when in February they began picking up again. This is the normal cycle unless something big happens to the economy.

This year {2006} the normal market cycle was broken, with a market that peaked in May. There was no summer "Selling Season" in any of the markets we now serve, which is now primarily the Inland Empire area of So. CA.

By observing the SFV statistics, I noticed in 1987 that when the Inventory got below a certain level, prices started rising {again}. There was a middle area where they seemed to be stable and another threshold where they started declining. We had gone from Under Supply in 1978-79, to an Over Supply in 1980-86 with values that had started to decline by at least mid 1982. By 1987 we were seeing improving conditions and a lot of absorption. By 1988 we had double digit price increases again.

In suburban and urban markets Balance seemed to be in the 12-15 month level. Second home markets operate slightly differently with typically higher levels of inventory as being normal.

Once Inventory gets beyond 15 months, the market could be measurably going down but not necessarily. By an 18 months Inventory level, almost all markets are going down. Even in the 2nd home markets, by the 24 month Inventory level, prices are declining.

If Inventory gets to be less than 12 months, prices usually start increasing. If the Inventory goes below 6-months, we are seeing double digit price increases.

For at least a year, more so in the Low Desert, there has been an increasing inventory of Listings in all areas of Southern California. The Desert Area MLS Inventory has about doubled in the last year. Here is what their daily statistics look like and some conclusions and trend analysis that could be done as it relates to this local market. Average Monthly Sales was used to include only 2006 data. The market was much better last year than this year.

This type of data is readily available to the appraiser today. With a little calculations and a paragraph of Market Analysis, the appraiser can diffuse client pressures. This can be shared with clients in the form of newsletters or email blasts, making the information separate from any individual appraisals {too}.

Market Conditions

Subject Market Area	**Desert Area MLS**	
	SFR's	Condo's
Inventory	5610	1680
Average Monthly Sales (8-month Average)	546	190
Months Worth of Inventory	10.3	8.8
Last Months Sales	325	88
Months Worth of Inventory based on Last Months Sales	**17.26**	**19.09**
Balance	12-15	

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Over Supply	15+
Under Supply	12-

Conclusion: The local market area has reached a state of Over-supply. Annualized statistics show slight price gains, but the last two months, prices have been declining even before deductions for Concessions are verified and adjusted..
This has been occurring even before an oversupply condition has been reached. It is believed that the irrational exuberance of the last three years has impacted normal market behavior. Investors and speculators have left the market.

Market Trend Analysis: The normal market cycle is for sales volumes to start decreasing after August. This year the volume began decreasing after May. It is most likely that volumes and prices will continue to declining during the next six months.

Category	Number	Ratio	%
New Listings (Daily)	144	3.7	
Back on Market	11		
Price Increases	26		
Price Reductions	92	2.4	64%
Contingents	8		
Pending's	27		
Scolds	39		27%
Expired	66	1.69	46%
Inactive	35		

Prices are declining in net terms, net of concessions, but appear stabilized based on annualized year to year statistics. That is the Average Sales Prices compared to the same Month last Year appears stable. This is what will show up on Dataquick type articles.

But what has happened is that prices started getting propped up by concessions, cash-back deals, 80-20 loans {100% financing), cars included in the sales, etc. Now, even with concessions, prices in the last two months show actual declines.

This phenomenon is being played out in many regions across the country. Essentially, all the areas that experienced the big price increases are subject to price declines now. And, all the regions that have housing prices beyond the affordability of 70% of their local households are subject to price declines now with rising interest rates, fuel costs, utility costs, unemployment and a loss of consumer confidence.

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Should appraisers be reporting the market trend based on annualized statistics when they know prices have already been declining for the last 2-3 months? I do not think so. What if they do not know what is happening to the market, but should know? What if they know, but do not report the facts? These questions might by the type posed to a jury. Juries in court rooms are not made up of appraisers and even if there is an appraiser on the jury, they have no sympathy for a licensed professional who did not do their job.

I testified in a Grand Jury case involving South Central Los Angeles properties in a mortgage fraud flipping ring. After giving direct testimony for the District Attorney and being essentially cross examined by the Grand Jury for over an hour, five appraisers were indicted for writing inflated and misleading reports. I met two of them in the hallway before we went in. Neither knew what they had done wrong. Both had found a "mentor" to sign their work and had gotten lots of loan broker clients and given service to them. What was the problem? They did not understand. They are not alone. After teaching the **Real Estate Fraud: Appraisers Liabilities and Responsibilities** seminar in Walnut Creek, a woman came up to me and told me she had attended because a friend had just gotten out of jail over a case like this and still did not understand why, what he had done wrong.

It is interesting to me that neither FNMA nor FHLMC have ever defined **Balanced**, **Over-Supply** or **Under Supply** conditions; although they ask appraisers to measure the conditions. Also, the appraisal organizations have never defined it, but are aware of the issue. It seems logical once one thinks about it that someone, some entity should have defined market conditions some time ago, maybe decades ago. Instead we were allowed to interpret the market any way we wanted.

Is it a hot potato, or political issue? I think not. It is easy to monitor and measure market supply/demand conditions and value trends. There is a direct correlation. So why no text or training on this subject? I am not sure.

What I am sure of is that we were licensed to make it easier for lenders, investors and mortgage insurers to sue us. The only thing USPAP was designed for was lawyers who sue appraisers and enforcement actions at the state and federal levels.

The previous MLS data seems very alarming at first when you realize the ratio of Sales to new Listings is very low at **27%**, Expired Listings to New Listings is high at **46%**, and Price Reductions to New Listings is high at **64%.**

Whenever the ratio of Sales to New Listings goes under 50%, inventory build up will occur. In the current market, after all the exuberance of the recent past, we can anticipate price declines to occur before a true Over-Supply condition has been reached. This is in part due to the Housing Affordability Index {www.car.org} for the Region, which is very low, with most segments being under 15%.

The fast run up market areas that experienced double digit price increases several years in a row and that have Affordability Index numbers under 25%, are subject to a market correction in prices in the near term. If interest rates go up, prices will correct further. If gas prices continue upward, the correction will get larger.

Use these concepts, practice with it and see if it works for your area. Knowing what the Supply conditions are in your markets is important to what we do for a living. Not knowing is irresponsible to your clients. Knowing the changes taking place in the markets you work is important to delivering a credible report. Test these concepts, see where Balance is in our markets, and use it as your best defense. Actual knowledge based on primary research is a good thing. Waiting for something to be published in the paper that you can quote will only get us in trouble in a down market.

Prove me wrong, write to FNMA/FHLMC, the appraisal organization you are a member of, write a rebuttal based on actual data researched and analyzed by you. But be aware that many people or entities that rely upon appraisals, already know what is happening in the market. Why not mirror what the market is actually doing as it happens. What a concept! Do you think we individually could improve our reputation by always being on top of the markets we serve? You bet. Staining ones reputation, whether out of ignorance or willful behavior, takes years to repair. I know, because it happened to me in 1982. You do not need to let it happen to you. We each have the opportunity to create a clean reputation. More appraisers have been **Blacklisted** in the few months than in the last several years, as lenders and investors pull in and become more concerned about values. Too bad they do not take the client pressures off of the appraisers in the trenches; they continue to allow their loan brokers and agents to practice economic coercion on the lowly appraiser. In that regard, things are as they want them.

Those appraisers who embrace the changing market conditions, measure and analyze what is happening; will float to the top like cream in a can. Create market demand for yourself by being analytical, articulate and accurate in your measurement and reporting of the market conditions in the areas you maintain geographic competency. If you do not maintain geographic competency, start by checking on Supply, Demand conditions and looking at the statistics that reflect all activity. Hunting for three sales to complete a report is not all that is expected and presumed of the appraiser.

Sure, you can't do all that is actually expected for the few hundred dollars the lender market wants to pay, but we are all expected too by virtue of the certifications made.

Appraisers have been set up in this regard and it is unfair in my opinion. I wrote about this in an article entitled Appraiser Liability, Their Ought To Be a Law which was published in The California Appraiser in 1999, in the Appraisal Journal in 200 and in Valuation 2000. The article is available on-line at the Lum Library at www.appraisalinstitute.org

If the lending industry wants fast and cheap, they should give us a **Hold Harmless Agreement** to protect us from any action or cause of action that arises out of our negligence; they should not be able to sue later because we gave them good service, cheap and fast service non-the-less. With the change in Scope of Work, we should be able to negotiate for fast and cheap appraisals that abridge and abrogate the appraisal process in order to give customer service, why not.

Unfortunately, the lawyers for the lenders have it all figured out. Lenders sue apprisers more than any other entity. Well, at least the lender pipeline, which includes the lender or investor, mortgage insurer or regulator. In recent years, buyers are suing in larger numbers, coming in at number two.

Have fun with these concepts, try them out and see how they work for you. If they work well, then good. If you can modify them to make them work, let me know what works in your area.

In a declining market, closed sales alone may give a false read of the present value. If values are going down at double digit prices, a six month old sale will give a really false read unless you actually make the appropriate downward adjustment. Even then the current listings and pending sales might come in lower. We are on the cusp of this market; it will be a slippery slope that will require true skills to navigate. Black Diamond runs are ahead of us, knowing how to snow plow will not work, true skills need to be developed to make it safely down the slope without getting hurt. Speed kills on slippery slopes. Control and skills will keep us safe and allow us to go through the trough to the bottom and come out the other side. See you at the bottom, take your time, no rush, be safe.

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