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Applying Forecasting to Local Markets

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Before taking a look at views from appraisers in the Midwest and California as a microcosm of where the real estate market is and may be heading, Martin says it is important to have a basic understanding of forecasting.

By Donald J. Martin, SCRP, RAA, GAA

What is reasonable and what is not reasonable in estimation of the “anticipated sales price” requires an understanding of the concept of forecasting in every appraisal. “Forecasting is the process of analyzing historical trends and current factors as a basis for anticipating market trends. A forecasting adjustment is then applied to reflect any impact these trends will have on the subject property’s marketing time and sales price” (Source: The Relocation Appraisal Guide, 2001).

Relocation appraisers must keep in mind when completing a Worldwide ERC® Summary Appraisal Report that forecasting requires a marketing time not to exceed 120 days. When marketing time is normally more than 120 days for the subject property being appraised, a forecasting adjustment will be required. With a mortgage appraisal, an adjustment would not be required when the marketing time is normal for the area, but is in excess of 120 days. This can be the most significant difference between an appraisal done for a mortgage and an appraisal done “to develop an opinion of the anticipated sales price for a relocating employee’s residence” (Source: The Relocation Appraisal Guide, 2001).

When marketing time becomes significantly more or less than 120 days for the existing supply of homes, a forecasting adjustment may be appropriate. For example, take a look at the local market in Orland Park, IL, according to the Multiple Listing Service (MLS) of Northern Illinois. During the preceding year for attached single-family homes from September 20, 2003, to September 19, 2004, there were 396 sales that ranged from $91,900 to $480,000, with a mean sales price of $195,930, a final listing price of $199,725, and an average reported marketing time of 40 days. On the surface, a marketing time of 40 days reflects a healthy marketing time well under 120 days. After further analysis, this area, as well as many others, does not adequately reflect the sum total of marketing times in many situations where the property has been re-listed by another broker, or has been taken off the market for a short period of time, and re-listed by the same office.

A further evaluation of existing inventory often is more telling than simply a view of the sales only. But neither have much meaning as an indication of where the market may be headed without using both together. Within the same market area, there are 134 listings of single-family attached homes that are listed from $112,900 to $442,000, with an average asking price of $232,275, and an average time on the market of 76 days. By revisiting the sales data with 396 sales in a year, there is an indicated absorption rate of 33 attached homes per month. With a current inventory of 134 homes, this indicates that inventory will be sold in approximately 4.06 months, or

121.8 days. A logical analysis of this data tells us that most homes reasonably priced should sell within the Worldwide ERC® guideline not to exceed 120 days, and a forecasting adjustment probably will not be necessary.

Other factors should be considered in evaluating this information. What is typical for homes in a particular development within this marketing area may be significantly different. Consider looking at the same information in appraisals completed one year and two years earlier, and breaking it down to quarterly, or monthly, to establish seasonal and longer term trends.

While the current scenario indicates a forecasting adjustment is not necessary, what if the supply was to increase to 185 homes? Based on the same absorption rate of 33 homes per month, an inventory of 185 homes would represent a 5.6 month supply, or about a 168 day supply. Since the supply exceeds Worldwide ERC® guidelines by 48 days, the appraiser must consider what it will take to sell the home within 120 days. The appraiser also should consider whether the subject's marketing time will be typical of the market at large. Are there more relevant sales and listings within a smaller segment of the market to deduce and calculate the normal marketing time for the subject property?

When calculating an adjustment for forecasting, the appraiser should see if there is enough data from which to do a paired sales analysis. This requires finding homes that have sold within the marketing time of less than 120 days, and comparing them with homes that take more than 120 days to sell in order to extract an adjustment. Another method is to consider the holding cost for time in excess of 120 days, and consider this as a possible negative forecasting adjustment. The adjustment should be evaluated in the context of properties that have sold in more than 120 days versus less than 120 days to determine if the adjustment would be reasonable for the subject property. Last, consider the probable listing price for the subject property multiplied by the typical list to sales price ratio, which equals the forecasted sales price for the subject property. This indication will provide a double check to see if the extraction from the paired sales analysis, or an indicated holding cost adjustment subtracted from each of the sales comparables, is consistent, and, most important, reasonable.

Whether or not the housing market is in a housing bubble and what that means has been a source of considerable disagreement. According to the Federal Reserve Bank of San Francisco Economic Letter, dated March 7, 2003, economist John Krainer said, "A house price bubble can be defined simply as a deviation of the market price from the fundamental value of the house. The definition implies, however, that identifying a bubble as it is developing will not be so easy, since the fundamental value of a house is generally unobservable."

Housing Market Supply and Demand

While the "fundamental value" may not be readily observable, this does not mean to suggest that warning signs should be ignored. There is a great array of economic factors that influence the overall health of the housing market at large: job growth, wages, and interest rates, to name a few. In more simple terms, the potential for a drop in price or slowdown in increasing prices in the market can be measured by a growth in the supply of homes while demand for homes falls, or remains the same.

Some analysts point to the disparity between rentals and home value, where rentals in a location are significantly inadequate with respect to covering the expenses of ownership, including debt (mortgage payments). Property values may continue to increase for a period of time, but as speculators continue to buy properties with the idea of selling them at completion, or even renting them for a short period of time, there may be the potential of creating excess supply in some market areas as speculative investors are unable to cover expenses and debt and realize the need to liquidate.

Somewhat related to the inability of the speculative investor as a lessor (owner) to achieve rental prices adequate enough to cover expenses and debt, is the situation when more buyers are paying a greater percentage of income toward debt (mortgage expense). As the percentage of income required for the mortgage increases, some buyers will be pushed out of the market and make the decision not to move. In most scenarios, such as those that occurred in the early 1990s, it takes only a small percentage of buyers withdrawing from the market to negatively impact the market as a whole. Thus, the importance of studying supply and demand from the appraiser perspective can play a major role in predicting and forecasting future home prices.

In recent years, while interest rates continued to fall, most, but not all, sectors of the United States real estate housing market have faired well—generally near an annualized rate of 7 percent. Much of the market may have been fueled to some extent by low-interest rates for home equity loans, refinancing, and new home purchases. Many homeowners used new found equity for purchasing major improvements, automobiles, and durable goods. Where will the economy be as interest rates slowly continue to rise? If real income does not increase, and home values increase slightly, fall, or remain flat, how will this affect a transferee's expectation about the sale of his or her home without actually delaying the sale of the home?

Even now, despite Illinois having an average 7.2 percent increase in the median home price from the 2nd quarter of 2003 versus the 2nd quarter of 2004, there are segments of the market where the median has deviated greatly. In the Barrington, IL, market area, prices for the same time period dropped by as much as 19.9 percent, and in Chicago, IL, rose by as much as 16.3 percent (according to housing statistics from the Illinois Association of Realtors®, published September 2004). Within these markets, continued analysis is required before making assumptions as to their application toward specific properties. Was there a significant increase or decrease in the amount of new construction from the preceding time period as compared with the more current? Is the median home similar in each of the samples? If the median home found in each of the time periods is significantly different for the same market area, then consider using paired sales—finding nearly identical homes in each time period and then comparing to see what the real rate of increase is for the subject property being appraised.

The Future of Forecasting

According to Scott Pettifer, CRP, MAI, SRA, of Pettifer & Associates, Santa Ana, CA, "many real estate professionals have been forecasting the housing market to hit the wall for two years, always hoping for a soft landing. Price increases of more than 20 percent have been common for the last two years in Southern California. According to published sources, Orange County home prices rose 21.6 percent in the second quarter of this year with a median sale price of $525,000, as of July 2004. The median price rose $90,000 from January to July 2004. Based on our office's sale appraisals and market analysis, sale price appreciation finally halted in July, and as the market entered August, it was evident that sale prices had peaked in most neighborhoods.

"Over the last three years, our office has needed to apply a forecasting adjustment on a relocation appraisal maybe twice. Most homes were selling in less than 30 days and market change (time) adjustments were needed as sale prices were escalating. During the month of August alone, softer market conditions called for us to apply forecasting adjustments on almost 50 percent of our relocation assignments.

"Many neighborhoods with multiple offers and bidding wars common just a few months ago, now have an abundance of homes available for sale as inventory has surged.

"In March 2004, it would have taken less than three weeks for the entire inventory of homes to sell in Orange County. As of July 2004, the inventory in Orange County would sell in 7.5 months. The steep contrast of current inventory compared to average standing inventory since 1998 is alarming.

“Many neighborhoods in Orange County have significant inventory and sellers have not reconciled listing prices to a market that is more favorable to buyers. Forecasting will be an essential tool for the relocation appraiser in the next 12 months to assure the appraised home sells in 120 days.

“Forecasting adjustments will become more widespread in the next 12 months as interest rates rise and inventory continues to expand. Appraisers with the ability and experience to develop and apply an appropriate forecasting discount will best serve the needs of the relocation client.”

Patrick J. White, CRP, White Appraisal, Inc., Cincinnati, OH, says, “my outlook is remarkably similar to that given when asked a couple of years ago. Presenting an ‘outlook’ of the future can be daunting and I was beginning to sweat a bit as the deadline for my response drew near. The anxiety was washed away with a good laugh I had the other night as I watched television. The presidential campaign ads are coming regularly at this early September composition period. The opinions and ads have demonstrated two completely opposite characterizations of our country’s economy. Bush ads point out recovery, job growth, increases in homeownership, positive, positive, positive. Kerry ads point to job losses to overseas workers, poor earnings, bad times, bad times, bad times. It is all quite the bore. My laugh came when I juxtaposed these two contradictory forecasts with my assignment: if these two guys with all their big brains and leadership and high-paid staffs can’t give a straight answer to the American people, then I don’t have to either.

“I’m not purposely going to mislead. But I don’t want my answer about my outlook of the future to be taken too seriously as irrefutable fact either.

“Here are two stats that are extracted from the Greater Cincinnati market:

1. Total single-family homesales are up 9.12 percent, from January to July 2004, over January to July 2003.
2. Single-family homesales are down 5.02 percent in the month of July 2004 over the month of July 2003.

“Translated, this means 2004 has been a better year in terms of the number of single-family homesales than 2003, except for July, the most recent month (of record) (Source: Cincinnati Area Board of Realtors® MLS).

“Is the market in a plummeting downturn? I don’t think so. I think that records cannot continue to be set year after year after year. I think people have spent the first half of 2004 scrambling to get their real estate stuff done and now the remaining part of the near future just may be ‘normal,’ or ‘average,’ in terms if numbers. I would like to point out that the past few years of many metro markets across the United States have been record-setting. Any current activity compared to the past two to four years may appear to be lackluster. To use an analogy from the baseball world, even Barry Bonds will have difficulty maintaining or ever repeating his incredible homerun record years; however, if Barry hits over 40 homers this year, it is still a heck of a year.

“In order for me to be a good relocation appraiser, having a tremendous knowledge of larger economic facts and statistics is not always necessary. It can be helpful. It also can be misleading. This is where my answer begins to mirror my response of a few years ago: my energy is spent on the ‘micro’ study of local real estate markets and sub-markets.

“The trends in these local housing pockets vary considerably from location to location within the Greater Cincinnati area. Here are some pearls that I think are relevant, whether in the southwest Ohio area or anywhere else in the U.S.:

1. Entry-level housing remains strong showing price increases and low days-on-market; this is due in large part to classic supply-demand imbalance: there is no competition from builders, there is a fixed supply of this lower-priced housing, there is ongoing demand from those who want to escape high-rent, and the like. This entry level varies from community to community, but in the four counties that I work, all housing under $150,000 to $200,000 fits this description.
2. The biggest trouble that I have observed is expensive housing that is newer and in an area that builders are still active and competing to capture potential buyers. The number of buyers is limited. The supply of existing, new spec housing, and 'paper' listings of new construction just waiting for a buyer exceeds demand. Depending on the degree of oversupply, I may make a negative forecast. I look for proof of this oversupply by the existence of a number of cases of long market time (over 120 days).
3. Interest rates are not everything, but they have a larger impact on buyer demand and property prices than almost anything—including 9/11, war, the stock market, and presidential election years.
4. Some consideration of perennial downturn in demand in November, December, and January.

"To conclude, I am forecasting neither an increase nor decrease in the volume of sales in the coming year. I am 'guessing' it will be about the same as this year. I am forecasting neither an increase nor decrease in the median sale price in the coming year. I am 'guessing' the median price will continue to go up like it has every year for the past decade or two. Neither will be overly consequential to my ability to accurately appraise properties for my relocation clients. I'll still rely on the real indicators from the immediate local market for my valuations. Isn't it a refreshing change to have an 'expert' telling the truth?"

The most important information that can be learned when considering a forecasting adjustment is that each market is unique and must be evaluated individually. Making an assumption for the market at large may give us an idea for forecasting the market in its entirety, but even in the best and worst housing markets over the last quarter century or so, there are nearly always examples of local markets that significantly over and under perform based on the expectations of the market. Thus, forecasting is best applied on a local level and after careful evaluation of a microcosm of that market. The market is best evaluated on an economic level where the homes chosen for comparison and study are most similar economically to the subject. In some areas, this microcosm of the market may be whole communities or consist of several communities; in others it may be a subdivision, part of a subdivision or a few blocks of homes.

What is most important in forecasting is to have individual experts who are in touch with the realities of the market to better forecast the sale of a specific home in a specific market.

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