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REAL ESTATE MARKET SOURCE

OF SOUTH CENTRAL WISCONSIN

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Dave Stark

The South Central Wisconsin real estate market experienced some of the most dramatic changes we've seen yet in the 2nd quarter of 2013. From skyrocketing sales, to increases in new listings, and the first meaningful increase in interest rates in years, this quarter had it all. While we expected the second quarter to be good, we didn't really expect it to be this good. That said, there were many cross-currents, sending some mixed signals about where we're headed next. But the momentum is decidedly positive, so let's break it down and see where we stand.

We'll start with sales. As reported three months ago, the first quarter was up a solid 19.9% over the first quarter of 2012, with Dane County leading the way at a 25.6% clip. In hindsight, that was child's play. The second quarter was up 29.2%, with both Dane and Sauk Counties up over 31%, while Columbia still lagged, up only 6.5%. Year to date, Dane County is up 29.8%, Sauk County is up 19.3%, while Columbia County trails at 1.9%. New listings picked up as well (see the new feature on listings in the Trend Watch section on the last page of this issue), but sales increased proportionately to keep months of inventory essentially even from the first quarter to the second in both Dane and Sauk. Months of inventory actually rose a hair in Columbia County, which continues to be the slowest of the three to feel the full benefit of improving conditions.

DANE COUNTY

	Single Family			Condominiums			Total Residential		
	2013	2012	2011	2013	2012	2011	2013	2012	2011
2nd Quarter Closings	1950	1529	1217	560	383	293	2510	1912	1510
Year-to-Date Closings	2826	2270	1821	837	553	458	3663	2823	2279
Active Inventory	2073	2451	3028	830	1146	1487	2903	3597	4515
Months of Inventory	4.8	7.1	11.1	6.6	13.4	20.4	5.2	8.4	13.0
3 Month Median	$228,000	$222,500	$218,000	$152,400	$142,500	$153,000	$214,013	$208,000	$206,100
12 Month Median	$220,000	$218,500	$224,000	$147,900	$147,000	$154,000	$205,900	$205,000	$211,000

SAUK COUNTY

	Single Family			Condominiums			Total Residential		
	2013	2012	2011	2013	2012	2011	2013	2012	2011
2nd Quarter Closings	224	165	148	23	23	19	247	188	167
Year-to-Date Closings	347	282	238	36	39	35	383	321	273
Active Inventory	653	675	731	140	152	177	793	827	908
Months of Inventory	11.6	13.9	17.8	19.5	26.8	33.2	12.5	15.2	19.6
3 Month Median	$142,000	$141,500	$124,700	$147,000	$135,000	$130,000	$144,900	$140,000	$125,000
12 Month Median	$137,000	$133,000	$135,500	$144,950	$137,500	$149,450	$ 138,000	$133,000	$138,000

COLUMBIA COUNTY

	Single Family			Condominiums			Total Residential		
	2013	2012	2011	2013	2012	2011	2013	2012	2011
2nd Quarter Closings	191	175	150	20	23	12	211	198	162
Year-to-Date Closings	285	277	225	30	32	16	315	309	241
Active Inventory	565	568	705	67	77	120	632	645	825
Months of Inventory	11.4	12.9	20.1	14.1	20.1	43.6	11.6	13.5	21.8
3 Month Median	$136,000	$135,000	$129,500	$128,500	$96,750	$158,500	$130,500	$130,000	$130,000
12 Month Median	$127,250	$126,500	$135,000	$127,000	$96,875	$99,000	$127,000	$125,000	$133,200

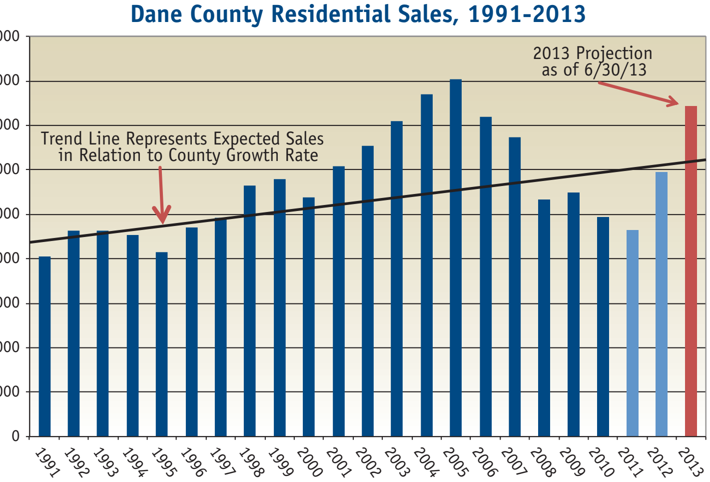
* Closed sales reported to the SCW MLS between 4/1/13 and 6/30/13. Data for all years pulled between the 12th & 16th of the month following the end of quarter. "Months of Inventory" represents the number of months it would take to sell the entire active inventory at the pace of sales for the most recent 12 months.

MARKET OBSERVATIONS

Median prices were up slightly in all counties, but not by much when you consider our relatively low inventories, particularly in Dane County. In fact, 12 month medians in Dane County remain below the level of two years ago, when the housing recession bottomed here. The three month median shows a little more strength, suggesting the possibility of some upward price pressure.

The main question in our minds is whether we can continue at this pace. For many reasons, we think the pace so far this year has been moderately overdone. There was certainly some pent-up demand coming off the sidelines this spring, and (suddenly) low inventories coupled with continued ultra-low interest rates fueled a virtual frenzy in some neighborhoods. In our last issue, we noted that sales in the first quarter projected out to a 6600 annual pace in Dane County. Now, at the end of the second quarter, 2013 projects out to about 7400 sales, which would be the third best year on record, behind only 2004 and 2005. The chart nearby illustrates this, along with a trend line that predicts what the "normal" level of sales would be if the number of sales grew at roughly the same pace as the population as a whole, somewhere in the neighborhood of 6000 to 6500 sales for 2013. While this estimate is very rough, it does suggest that our guess three months ago might be more realistic going forward. With today's tighter underwriting standards, staying at a pace close to that of the bubble years seems optimistic. With the torrid start to the year, a little cooling off might even be a good thing, lest shortages start to develop again, and prices move too fast.

Dane County Residential Sales, 1991-2013



Whether we're too hot, too cold, or just right, time will tell. What we know for sure is that the general tone of the market is far healthier than it was a couple years ago. But the process of normalizing markets is never linear, and sometimes can be messy. Nowhere is that fact more evident now than in the recent behavior of interest rates. Let's take a closer look, as rates remain one of the last, and most important, elements of the market that needs to get back to normal.

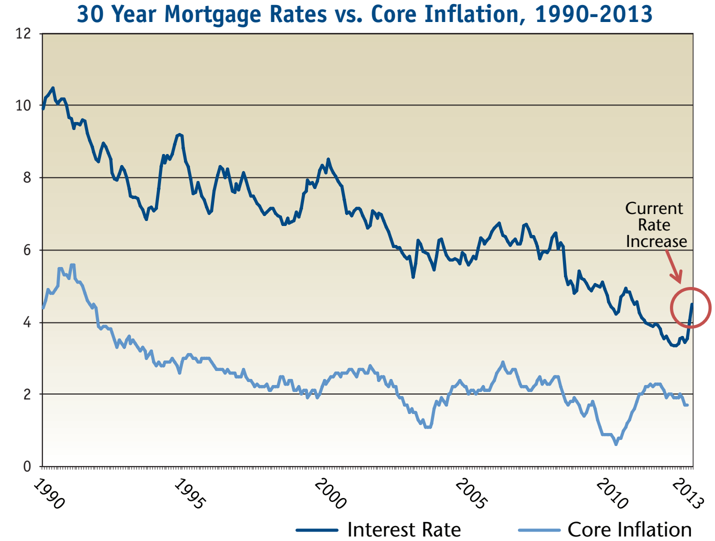
INTEREST RATES

For most of the past 3-4 years, we'd been telling our readers that interest rates would soon rise, and to get ready for it. The Federal Reserve had other ideas, and its extraordinary interventions in the financial markets caused interest rates to defy expectations, not only failing to rise but actually falling, bottoming out near 3.25% for the 30 year fixed rate mortgage late last year and early this year. This did not alter the near certainty that rates had to rise eventually. But it did become clear that "you can't fight the Fed", and so we stopped predicting that mortgage rates would rise soon, only that they would indeed rise someday.

Finally, in mid-June, the Fed announced that economic conditions were sufficiently improved that they might begin reducing their "extraordinary accommodation" in the form of buying treasury bonds and mortgage backed securities, known as "quantitative easing," or "QE," perhaps later this year. Despite the fact Chairman Bernanke made it clear that they would only start to taper if conditions continued to improve, the announcement was met with a sharp selloff in bonds, leading to a corresponding rise in interest rates. As we've been writing this edition of the Market Source, the 30 year fixed rate has ranged from 4.375% to 4.625%, roughly a full percentage point above the levels seen earlier this year.

Some in the media have already speculated that this news will be bad for the economy, and for housing. We do not share that view. Indeed, what many pundits seem to be missing is that rates are rising because the economy is doing WELL, and a better economy is good news for everybody, including housing. Plus, we can never forget that the interest rates of the past 3-4 years have been far lower than we've ever seen before, and are largely the result of manipulation by the Fed, not normal market forces. When people are more focused on what the members of the Fed Open Market Committee are doing, rather than economic fundamentals, something is not right. Count us as thrilled that the economy has improved to the point where the Fed believes it can function normally on its own. That's great news, and a strong economy is a much better platform on which to build prosperity than the manipulations of the central bank.

30 Year Mortgage Rates vs. Core Inflation, 1990-2013



Look carefully at the accompanying chart which tracks the 30 year mortgage rate, as reported by Freddie Mac, month by month since 1990. Even with the recent increase, rates were never as low as they are now until roughly two years ago. How quickly we forget that during the "bubble years" of 2000-2006, interest rates ranged from 5.5% to 6.5%, a level thought to be dangerously low at the time, and cited by many as one of the bubble's root causes. Why a 4.5% rate is now seen as potentially harmful to the economy is beyond us. Indeed, we're happy to report that while it's still early, we so far have seen no noticeable negative impact from this most recent increase in rates, and in fact, we see evidence (as we often do when rates rise) of people rushing to lock in today's rates before they go even higher.

In fairness, it's probably true that the very brisk market we've had in the first half of 2013 was driven at least in part by the record low interest rates during that time. By that reasoning, the second half of the year might well slow down a little bit at today's slightly higher rates, but we think that's ok considering the first half gave us a big head start. Remember, rates HAD TO go up someday, and we can't declare the market back to normal until interest rates are back to normal too.

How high will they go? The lower line on the interest rate chart above tracks the change in the annual core inflation rate. Notice the correlation over time between the two lines. In general, the 30 year rate is about 3-4% above the core inflation rate, sometimes more, sometimes a little less. Note that the two lines were closest over the past 24 months or so, a clear result of the Fed's intervention. If inflation over time remains around the Fed's target of 2%, we can probably expect equilibrium 30 year rates in the 5.5%-6.5% range. If inflation is higher or lower, rates will ultimately follow suit. Don't expect the process to be linear, however. Already, rates are falling back a bit as the market more fully digests the Fed's message. They may go lower yet before they go higher, or they may not. But over the longer run, there is no doubt that we will eventually have higher interest rates. We're looking forward to that day, because that will mean that the economy truly is back to normal.

HOW ABOUT AFFORDABILITY?

While we believe rising interest rates are both inevitable and healthy, it's true that rising rates do affect affordability on the margin. As we've explained in previous editions, a 1% increase in interest rates reduces purchasing power by roughly 10%. So at the very least, buyers would be well advised to act quickly if they want to be sure to take advantage of today's (still) low interest rates. But when do rising rates truly become a problem?

NAR Home Affordability Index

	Dane	Sauk	Columbia
Median Family Income	$61,913	$51,121	$57,805
Median Home Price	$205,900	$138,000	$127,000
80% Loan Amount	$164,720	$110,400	$101,600
30 Year Interest Rate	4.625%	4.625%	4.625%
Monthly Payment	$846.89	$567.61	$522.37
Annual Income Required	$40,650	$27,245	$25,074
HAI*	152	188	231

**The HAI equals Median Family Income/Annual Income Required x 100*

The National Association of Realtors (NAR) uses a measure they call the Home Affordability Index (HAI) as a rough gauge of general home affordability. Conceptually, it estimates whether a family in a given market with the median household income can afford the median priced house. It assumes that the borrower's principal and interest payment should not exceed 25% of gross monthly income at the current 30 year rate with a 20% down-payment. In Dane County, the most recent median family income as measured by the US Census Bureau is $61,913 per year. Our 12 month median price is $205,900. At 4.625%, with a 20% down payment, the median monthly mortgage payment is $846.89 per month. This is equal to 25% of an annual income of $40,650 per year. Our median family income of $61,913 is 52% higher than the income required. As you can see in the accompanying table, Sauk and Columbia Counties are even more affordable. By this rough measure, we have a long way to go in both price and interest rate before developing a problem with affordability.

This is of course a very simple index, and there is a great deal more that goes into determining whether a buyer actually qualifies to buy a particular home. It does not consider property taxes, credit scores, other debts, employment stability, or myriad other factors that go into underwriting a loan. Every situation is different, so you need to talk to a lender to determine what you can afford. But it does imply that housing today is still a bargain, and we urge savvy buyers to continue to take advantage of today's very favorable conditions.

LOOKING BACKWARD, LOOKING FORWARD

As we said at the outset, the 2nd quarter of 2013 was outstanding, but whether that level of activity can, will, or even should continue is a very different matter. All of us who endured the unprecedented difficulties of 2007-2011 have no desire to see it repeated. But we also can't forget that the seeds of that debacle were sown during the previous six years, when the prevailing attitude seemed to be that anyone should be able to buy any home they wanted, regardless of income, no questions asked.

There's been some speculation, again mainly in the national media, that another real estate "bubble" may be brewing, based on double digit price increases in some markets (see the 1st Quarter 2013 issue of the Market Source Newsletter at www.starkhomes.com for a more complete discussion of national price indexes). We disagree. From 2001 through 2006, lenders essentially stopped underwriting loans, giving money away to whomever asked for it. This led to over-building, mass foreclosures, excess inventories, and price declines. Today, despite very low interest rates, no lender is "giving money away." Underwriting guidelines remain very tight, and few if any loans are being made to buyers who cannot afford them. So, when interest rates do eventually return to full market levels, while demand may be cooled on the margin, mass defaults and excess inventories that accompany them are not at all likely. Plus, South Central Wisconsin has not seen the price volatility that so much of the country as measured by the national indexes has seen. As long as we don't return to the days of "no-doc" and "liar" loans, we don't foresee a repeat of the last recession.

We have long argued in this space for slow, steady, predictable real estate markets. The last quarter was manic, but our inventory is in balance, price increases have been muted, and with rates creeping up but still low, we have room to settle into a more sustainable equilibrium. As the recovery continues, incomes, employment, and household formations should increase. That sounds like the basis for a solid real estate market for years to come.

ADVICE FOR BUYERS AND SELLERS

BUYERS

Clearly, the days of waiting around for the deal of the month to come by are over, particularly in Dane County. In all but the highest price ranges, over a quarter of all accepted offers were either full price or over full price. The percentages were even higher in the City of Madison. Inventories are lean, but there's been an increase in new listings since May, and as the summer winds down, sales normally do too, leaving open the possibility of some good values among those properties left behind. But the very best are still selling quickly, so be aggressive if you want to get the home you want. Rates remain very low, but will drift up over the next 12-24 months, so there's a great deal to be gained by moving sooner rather than later. Your total cost of ownership probably remains lower today than it will be next year.

SELLERS

From a seasonal perspective, the best months of 2013 are behind us. Furthermore, as outlined elsewhere in this edition, there's a good chance the second half of the year will be a little more subdued due to seasonal factors, rising interest rates, and the waning of pent up demand. However, inventories remain lean especially in Dane County, and many buyers are still active. Prices seem to be firming up more noticeably in less expensive housing than in the high price ranges, but whether you should be aggressive or not in your pricing depends heavily on exactly where your home is located, and the specific supply/demand dynamics in your neighborhood. Pay absolutely no attention to national media reports or web sites on home prices. They will mislead you badly. Get specific advice from a professional. We probably won't know for sure where prices are going until this time next year, so it's still too early to be greedy.

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TREND WATCH

Likely direction next 6 months

Number of homes sold (12 Months)

	Dane	Sauk	Columbia	Direction
12 Months Ended 6/30/13	6,739	763	653	↑
12 Months Ended 3/31/13	6,164	706	644	
12 Months Ended 6/30/12	5,167	651	575	

Comments: Up roughly 30% from a year ago. We see the trend continuing up, but probably not as strongly in the second half.

30 Year Mortgage Rates

			Direction
June	2013	4.07%	↑
March	2013	3.57%	
June	2012	3.95%	

Source: Freddie Mac

The turn in rates is finally at hand. They're already over 4.5% at this writing, same as two years ago. How much higher is yet to be seen.

Median Sales Price – Single-Family & Condos (12 Months)

	Dane	Sauk	Columbia	Direction
12 Months Ended 6/30/13	$205,900	$138,000	$127,000	↑
12 Months Ended 3/31/13	$203,500	$136,750	$126,500	
12 Months Ended 6/30/12	$205,000	$133,000	$125,000	

Price increases continue to be moderate, despite low inventories. Rising rates will keep increases modest.

Inventories – Single Family and Condo

		Dane	Sauk	Columbia	Direction
June	2013	2,903	793	632	↓
March	2013	2,758	711	547	
June	2012	3,597	827	645	

The increase from three months ago is seasonal, so don't be fooled. Supplies will be very tight in Dane, but still high in Sauk and Columbia.

New Listings – Single Family & Condo

	Dane	Sauk	Columbia	Direction
2nd Quarter 2013	3,294	486	414	↑
2nd Quarter 2012	2,768	409	368	
Year-to-Date 2013	5,756	810	678	
Year-to-Date 2012	5,398	764	684	

A new feature for the Trend Watch. New listings accelerated in the 2nd quarter, as demand is attracting supply.

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