

September 15, 2006

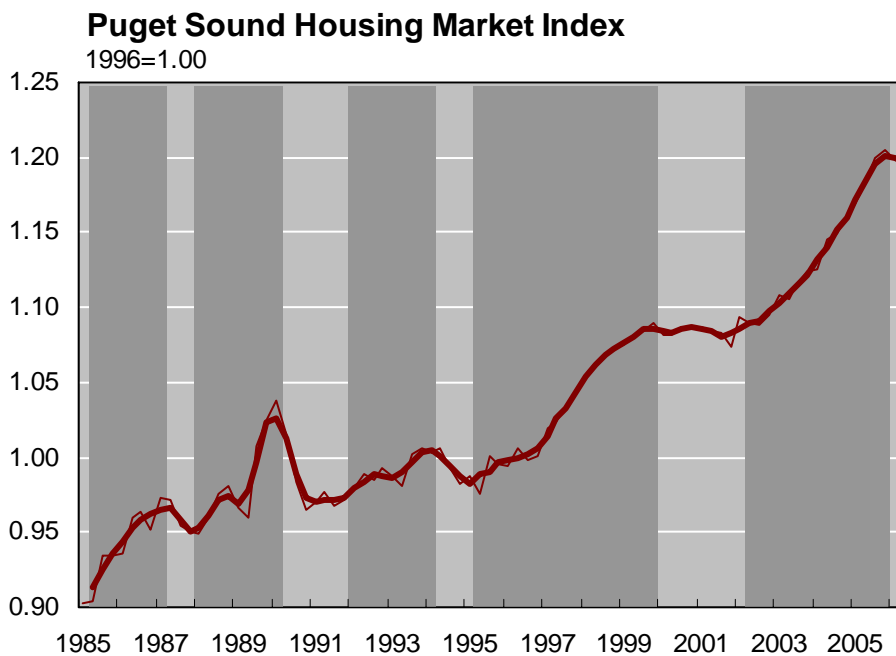
The Puget Sound Housing Market Index

At the risk of prematurely calling an end to the party, the local housing market has finally turned down, according to our composite index of residential real estate activity. The index, which is smoothed to eliminate erratic quarter-to-quarter movements, fell at a 0.9 percent annual rate in the second quarter of 2006. Revised data revealed that the index declined at a 0.3 percent rate in the first quarter, indicating that the housing market peaked at the end of 2005. The unsmoothed index, which dropped at a 1.7 percent annual rate over the last two quarters, tells the same story.

The fall-off in the housing market index is largely attributable to declining home sales. After hitting 83,200 in the third quarter of 2005, an all-time high, annualized closed home sales fell to 76,100 in the second quarter of 2006. Sales in the second quarter declined at an 11.0 percent annual rate. As noted in the September newsletter, the slump in local homes sales is following the national pattern, at least so far.

Also contributing to a weaker index is an increase in the time it takes to sell a home. Reflecting the slower pace of sales and a growing inventory of unsold homes, the average time on the market jumped from 44.3 days in the fourth quarter of last year to an estimated 56.0 days in the second quarter of this year. Not since the second quarter of 2004 has selling a home taken so long.

The only component still boosting the housing market index is the average closed sales price. In fact, home prices continued to soar as if the market was still in its prime. Home prices



A rise in the index indicates a stronger housing market.
Shaded areas show periods of expanding housing activity.

escalated at a 17.1 percent rate in the second quarter, reaching an average of \$390,600. Unlike home sales, local prices are out of step with national prices. While Puget Sound new and existing home prices were up 15.0 percent over the year in the last quarter, U.S. existing home prices were up only 0.9 percent. We interpret this disconnect as a warning that the Puget Sound home price appreciation rate will experience a sharp decline in the not too distant future.

The forces shaping the housing market are a mixed bag. The fundamental demand for housing, as represented by the housing demand index, remains strong. The index increased at a 1.0 percent annual rate in the second quarter. Jobs grew at a 1.6 percent rate, while the household formation rate climbed at a 56.7 percent rate. Regarding households, the economic recovery has led to a surge in population, which is now reaching its high point. Consequently, the number new households created in the region jumped from 15,200 per year in the second quarter of 2005 to 24,100 in the second quarter of 2006. With home prices still rising at a double-digit rate and the mortgage rate remaining under 7 percent, there may still be a few gutsy or foolish speculators left in the market.

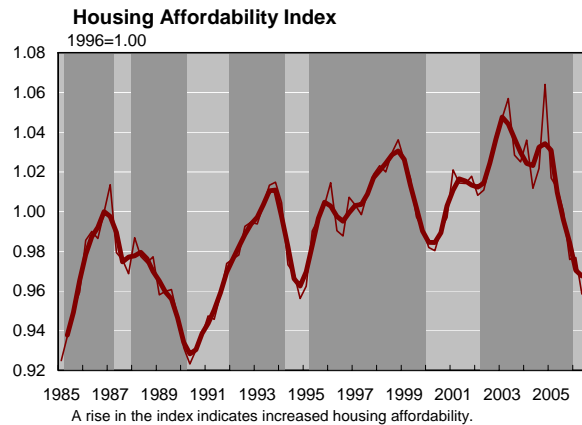
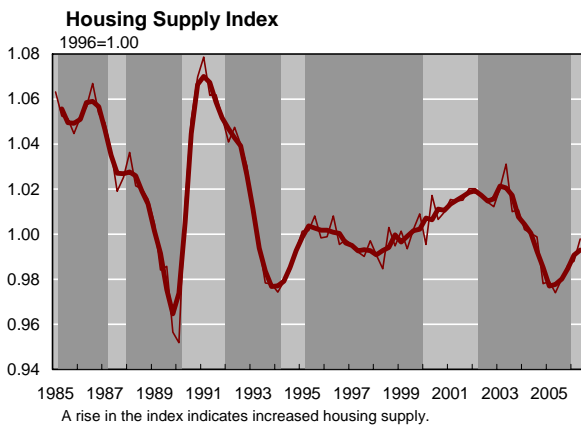
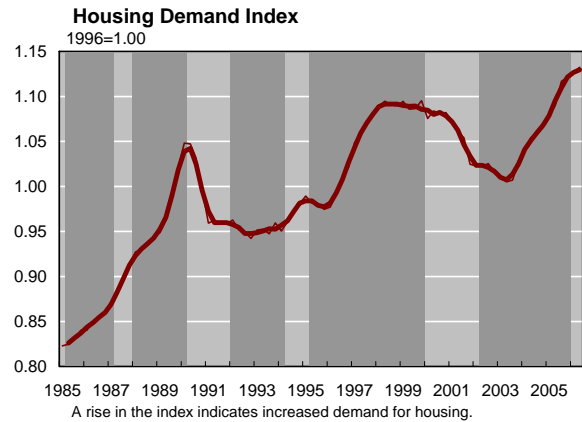
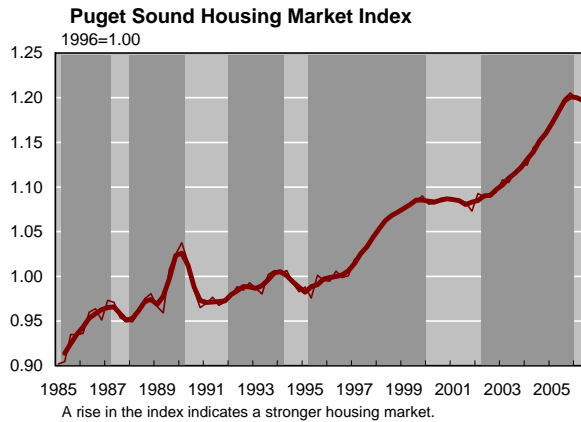
The buoyancy of the economy notwithstanding, the decreasing affordability of homes is weighing down the housing market. The housing affordability index fell at a 1.1 percent annual rate in the second quarter. Average household income rose at a 6.1 percent rate, but that was not enough to keep up with the 17.1 percent jump in home prices and the 0.36 percentage point increase in the mortgage rate. In the last year, the annual mortgage payment on an average-priced home has leaped from 17.0 percent of average household income to 21.5 percent.

The Puget Sound Housing Market Index

Seasonally Adjusted and Annualized

	2005:2	2005:3	2005:4	2006.1	2006.2	Annualized Percent Change	
						Over Last Quarter	Over Last Four Quarters
Housing Market Index (1996=1.0)	1.184	1.196	1.201	1.200	1.197	-0.9	1.1
Unsmoothed index (1996=1.0)	1.183	1.199	1.206	1.199	1.196	-1.1	1.1
Closed home sales (units)	81,737	83,182	81,102	78,257	76,112	-11.0	-6.9
Time on the market (days)	47.1	44.6	44.3	48.4	56.0	63.3	18.9
Average closed sales price (\$)	339,672	353,809	370,046	374,569	390,614	17.1	15.0
Consumer price index (1982-84 = 1.0)	2.006	1.999	2.021	2.036	2.078	8.3	3.6
Housing Demand Index (1996=1.0)	1.095	1.109	1.122	1.127	1.130	1.0	3.1
Unsmoothed index (1996=1.0)	1.090	1.117	1.121	1.127	1.132	2.0	3.9
Employment (thous.)	1713.3	1726.2	1746.0	1767.8	1774.8	1.6	3.6
Unemployment rate ¹ (%)	5.2	5.1	4.9	4.4	4.5	0.1	-0.7
Household formation (number)	15,155	25,110	19,340	21,112	24,106	56.7	59.1
Average closed sales price (\$)	339,672	353,809	370,046	374,569	390,614	17.1	15.0
Mortgage rate ¹ (%)	5.72	5.76	6.22	6.24	6.60	0.36	0.88
Housing Supply Index (1996=1.0)	0.978	0.980	0.985	0.991	0.993	0.9	1.6
Unsmoothed index (1996=1.0)	0.974	0.980	0.986	0.988	0.998	4.0	2.5
Housing inventory (units)	14,425	14,889	15,784	15,663	17,334	42.7	20.2
New housing construction (units)	24,591	25,749	25,213	26,540	25,269	-19.2	2.8
Housing Affordability Index (1996 =1.0)	1.010	0.996	0.984	0.970	0.968	-1.1	-4.2
Unsmoothed index (1996=1.0)	1.012	1.000	0.976	0.977	0.958	-7.5	-5.3
Average closed sales price (\$)	339,672	353,809	370,046	374,569	390,614	17.1	15.0
Household income (\$)	102,674	102,595	104,057	106,067	107,680	6.1	4.9
Mortgage rate ¹ (%)	5.72	5.76	6.22	6.24	6.60	0.36	0.88

¹Percent change calculated as simple change in variable.



Explanatory Notes

The Housing Market Index

The housing market index is a quarterly measure of residential real estate activity in the Puget Sound region (King, Pierce, Snohomish, and Kitsap counties). The index is composed of three indicators: the number of closed home sales, the average time on the market, and the ratio of the average closed sales price to the Seattle consumer price index (i.e., the relative average closed sales price). The composite index, which has a value of 1.0 in 1996, is designed to rise or fall as the housing market improves or deteriorates. An increase in home sales, a decrease in the time on the market, or an increase in the closed sales price relative to the consumer price index, all else being equal, leads to a rise in the index.

The Housing Demand, Supply, and Affordability Indexes

The housing market index is supported by three other composite indexes: the housing demand index, the housing supply index, and the housing affordability index. Whereas the housing

market index portrays current conditions in the residential real estate market, the supporting indexes help to explain the market's performance.

The housing demand index is composed of four variables: regional employment, the unemployment rate, new households, and speculative demand (the home price appreciation rate relative to the mortgage rate). The last variable represents certain kinds of speculative behavior (e.g., buying a home for fear of being priced out of the market) that sometimes affect home sales. The housing supply index has two components: new housing construction (housing permits lagged four quarters) and the inventory of homes for sale. The housing affordability index incorporates three variables: average closed sales price, average household income, and the mortgage rate. This index is based on a measure of affordability published in *The Puget Sound Economic Forecaster*.

Construction of Indexes

Construction of the composite indexes follows standard procedures (*Survey of Current Business*, November 1987, U.S. Bureau of Economic Analysis). The method entails calculating, standardizing, and combining quarter-to-quarter changes for each component of the composite index. Data to construct the housing market index and its supporting indexes come from two sources: the Northwest Multiple Listing Service monthly reports on residential real estate activity and the economic data base of *The Puget Sound Economic Forecaster*, which is a compilation of information from various government sources (e.g., Washington Employment Security Department and the U.S. Bureau of the Census).

Interpretation of Indexes

An upward movement in the housing market index indicates improvement in the residential real estate market, as measured by home sales, time on the market, and the ratio of the average closed sales price to the consumer price index. Such a change is usually associated with an increase in the demand for housing or an increase in the affordability of homes, which are represented by rises in their respective indexes. On the other hand, an increase in the supply of housing, depicted by a rise in the housing supply index, is often indicative of a weakening housing market.

Movements of the housing market index can be explained by changes in the supporting indexes. Although the housing market index and the housing demand index are composed of different variables, they tend to move together over time, implying that conditions in the residential real estate market (i.e., home sales and time on the market) are largely determined by economic and demographic factors (i.e., employment growth, the unemployment rate, and the formation of new households). A good example of this relationship was the surge in home-buying that accompanied the Boeing expansion and the high-tech boom of the late 1990s. There are other occasions, however, when the housing market is subject to cross-currents. For example, in spite of a rising demand for housing in 1994, a decrease in the affordability of homes stemming from a jump in the mortgage rate led to a downturn in home sales.