All Eyes on Home Market in San Diego

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SAN DIEGO — When the housing market here was red-hot 18 months ago, Alex Flores could buy a downtown condominium with as little as $5,000 down and sell it six months later for a tidy profit of $200,000.

Now, Flores says, those easy-money days are over.

Flores, a self-described real estate "flipper," is trying to sell two condos. But neither has drawn an offer after being on the market for more than a month, even though he's willing to break even on one and reduce the price on the other.

"It's getting trickier now," said Flores, 30, who became a full-time property investor three years ago after a short career as a senior financial analyst for a movie studio. "Everyone thinks this has peaked."

Once Southern California's hottest real estate market, San Diego is feeling a real estate slowdown. It's a trend also starting to be seen in other regions, such as Las Vegas, Denver, Boston and Washington, D.C.

Dramatic rises in home prices, particularly on the West and East coasts, have sparked a nationwide debate about whether the housing market is engulfed in a bubble that is about to burst.

San Diego has become a focal point of that discussion. Those who believe the market is about to implode say San Diego's cooling could be among the first signs of a pronounced downturn or even a possible crash in California. But housing industry leaders say the slowing in San Diego reflects the normal damping of a sizzling market that made millionaires out of many homeowners and investors. Because San Diego was the region's hottest market, it's not surprising that it's one of the first to simmer down and return to more normal conditions, they say.

John Karevoll, chief analyst at DataQuick Information Services in La Jolla, which tracks home prices, called San Diego "our statistical canary in the mine shaft."

"It is further along in the current cycle, and what happens there could predict what will happen elsewhere," he said.

After more than doubling in the last five years, jumping almost 30% in one 12-month period, San Diego-area home prices are rising more modestly — 6.3% on a year-over-year basis as of June.

Amid concern that prices may be peaking, more homeowners are selling, doubling the number of single-family houses and condos on the market from a year ago. Yet fewer are finding takers. Homes that a year or two ago sold virtually overnight — in many cases triggering bidding wars — are on the market for weeks.

Homeowners such as John Kemper are finding additional windfalls harder to come by.

Kemper figures his town home in Rancho Bernardo, a suburban community in the northern part of the city, surged about 50% in value since he bought it new two years ago. Seeking a bigger house for his five kids under age 8, Kemper put the unit on the market early last month at an asking price of $624,975.

But it's competing against about a dozen others for sale in the neighborhood. With a dearth of offers, many sellers have set price ranges instead of a fixed listing price. Kemper cut his price to $615,000.

"I have lowered the price and am the lowest in the neighborhood," he said, comparing his unit to others of the same style and size.

Other once-torrid markets are also catching a slight chill. The pace of home price increases in Los Angeles, Orange and Ventura counties is becoming more sluggish, although not as much as in San Diego. Housing activity and price appreciation have moved from "hot" to "normal" in Boston, the tight Washington, D.C., market is starting to see home inventories rise, and Manhattan's condo market "was less frenzied" in the most recent quarter compared with the spring, according to a **Federal Reserve** report last week.

These markets, like most of California, enjoyed huge price increases thanks to a strong economy, persistently low mortgage rates and the growing use of loans that let buyers squeeze into homes with far less than the traditional 20% down payment.

Five and a half years ago, San Diego ignited California's housing boom — and to a large extent the nation's — when home prices started rising by at least 10% year over year.

It didn't hurt that San Diego was enjoying a downtown renaissance, showcased by its new Petco Park baseball stadium, and a surge in jobs in its key industries of biotech, defense and healthcare.

Downtown "has gone from an oceanfront of dilapidated warehouses and homeless people to a great place to live," said Thomas Noon, head of the California division of builder D.R. Horton Inc., which has built or is building several downtown condo complexes. "Five years ago, few people would have considered living there, but now they're fighting to get in."

Demand elsewhere in San Diego County also helped drive sales to record levels. And the seemingly relentless escalation in prices gave homeowners a feeling of wealth.

"Many people have made a fortune. All you have to do is be here and own a place," said San Diego-based financial advisor Christopher Van Slyke.

Now, several factors could cause a more pronounced slowdown here, analysts say.

One is the far-below-average level of affordability. By one measure, only 9% of households can afford the area's $493,000 median home price — the level at which half of all homes sold for more, half for less. By contrast, affordability statewide is 16%; nationwide, it is 50%.

Another worry is the high level of risky loans. San Diego has been a standout in the use of unconventional lending. It ranks No. 1 in the use of so-called piggyback loans, which let borrowers with low down payments finance a home purchase without paying for mortgage insurance. And the majority of buyers in San Diego still use loans with an "interest only" option, a type of adjustable rate mortgage in which borrowers need only pay interest in the first few years before the monthly payment mushrooms.

"In order to purchase a home, a lot of people have to resort to risky mortgages," said Celia Chen, an economist with the national research firm Economy .com in West Chester, Pa.

Yet another risk stems from the higher than normal level of activity by investors. They accounted for 14% of all San Diego-area home buyers in June, versus the historical average of 11%, according to DataQuick.

All of this unnerves many economists, who see a recipe for possible price declines in San Diego and elsewhere. They expect investors will start unloading properties when they see their returns diminish. Many holders of riskier mortgages, already stretching to meet their monthly payments, could default when their loans reset at higher rates in the next few years. Mortgage rates started rising recently.

Mortgage insurance company PMI Group has pegged San Diego as the nation's third-riskiest market, with a 53% chance of home prices dropping in the next two years.

Only Boston and New York's Long Island rank higher on the company's risk index.

"Those of us with long enough memories know that real estate is cyclical," said Mark Milner, PMI's senior vice president and chief risk officer.

"But we've never seen a cycle with so many of these kinds of loans, so nobody knows how the market will react if there's an economic shock."

Such a shock could come from a wave of job losses. Although San Diego added 20,000 jobs between June 2004 and this June, the biggest gains were in jobs related to real estate, such as construction, according to Hanley Wood Market Intelligence, a research firm.

Analysts say a deflating housing market could reverse that trend, much as a contraction in the aerospace industry touched off a Southern California housing market downturn in the early 1990s. San Diego home prices were virtually flat for six years.

The signs of a possible repeat performance are increasing.

"Houses that would have sold easily a year, a year and a half ago won't sell so easily now," said Parham Firouzi, a real estate agent in Rancho Bernardo. "There's a lot more negotiating going on, and buyers aren't going over the asking price."

And, he said, it takes an average of about six weeks to close a deal on a single-family home, double what it took a year ago.

There are other, more subtle signs of slowing. For instance, new-home developments in the coastal city of Carlsbad were selling houses at a rate of six or seven a month a year ago. Today, they are still selling out, but at a slower pace of about four or five a month.

Noon, of D.R. Horton, said his company's sales pace had slowed, particularly among downtown condos, as price increases slowed dramatically since their peak in early 2004. Still, Horton's homes "are selling plenty fast," he said.

"This is good news for the market," Noon said. "It shows that the market has reached more of a balance" between supply and demand.

Alan Gin, an economics professor at UC San Diego, said a crash is unlikely, predicting that the region will continue to create jobs at a healthy pace, which will support demand for housing. Still, he said, many new jobs are in the lower-wage category.

"What you've got here is a slowing situation and not much of a chance of a severe downturn," he said. "To have a downturn, you need a triggering event, such as massive job loss."

Investor Flores, who says he made close to $1 million in the last three years buying and selling new condominiums in downtown San Diego, is branching out to markets he considers undervalued, such as Houston. He's still investing in San Diego, but with a longer-term view. He recently put a down payment on a new downtown condo that won't be ready until 2008.

"I'm still betting on San Diego," Flores said, "but not as much as before."