

The Forecast by Lawrence Yun

The Federal Reserve's tightening of monetary policy has contained inflation. After a rise in the consumer price index (CPI) of 3.4% in 2005, the CPI will decelerate to 3% in 2006 and then to 2% in 2007. Low inflation will keep long-term bond rates at manageable levels. Further, the Federal Reserve can back off their interest-rate increases after one more rate hike at the end of January.

What will happen with mortgage rates? While the 30-year fixed rate will remain under 7% for the next two years, expect modestly higher rates in 2006 – 6.3% to 6.7% – compared to the 5.5-6% rates of the past three years. These higher rates will begin to rein in the super-hot housing activity that we've seen over the last three years. Indeed, in some pricier regions of the country homebuyers have already been stretched to the max. Look at San Diego where interest-only and adjustable-rate mortgages are prevalent; the market there could encounter difficulty in bringing in a new set of homebuyers. Prices will hold their ground, but sales activity will come down measurably.

The more affordable regions of the country – the vast chunk of middle America in the Central and Mountain Time zones – will fare better since modestly higher rates will not greatly impact affordability. Anyone with a job and a good credit can pretty much afford a commonly available \$150,000 home. Thus, home sales in the middle regions of the country will outperform the coastal regions.

But let's look at one particular area of the country. There is one coastal market that could outshine them all. Seattle, home of the 10,000 Microsoft millionaires, Costco, Amazon.com, Nordstrom and numerous other "trendy" shops and companies, will lead the country in home price growth in 2006.

The latest median home price in the Seattle-Tacoma-Bellevue metro region was \$325,000. That is 50% higher than the national median home price. Prices rose by 56% in the past 5 years – about the same as the national increase. However, the greater Seattle market was a significant underperformer when compared to other major western cities. Home prices had essentially doubled over the 5 years in Los Angeles, San Diego, Sacramento, Las Vegas, and Phoenix. Moreover, Seattle home prices in recent years were only 45% of the prices in San Francisco – that is much lower than their historical 55% of home prices in the City by the Bay. All the while, the cerebral Seattle residents (nearly half of adult population has college degrees – the highest percentage in the country) were scratching their heads looking for jobs. The high-tech meltdown led to 129,500 fewer jobs in the Emerald City from their peak in December 2000 to the trough in January 2005. The jobless rate had touched 7.3% in the middle of the downturn – near the top among major cities.

But a major change is occurring in Seattle's local economy. Boeing is getting bombarded with overseas orders for its aircraft. The area's ports are busy from a significantly higher international trade volume, both exports and imports. And a big turnaround is underway in the nation's technology sector. Jobs in the local region rose by 57,100 in the past 12 months. Its job creation rate of 3.5% is more than twice the national average and unusually high among large metro markets.

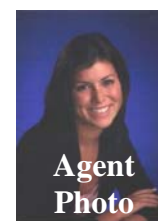
Seattle has a lot of catching up to do and its home prices would need to rise by essentially \$100,000 just to be at a relatively even position with other western cities. One may even argue that Seattle's relative position should be rising over time due to its brainy population (to the extent that income is associated with educational attainment) and its trend-setting lifestyle.

Extensive water views throughout the region and the looming snow-capped mountains help draw new residents. The forecast is for Seattle's median home price to rise by 40% over the next two years, even as most of the country's housing market will undergo a soft landing. Such a price rise means a housing equity gain of \$130,000 for a typical Seattle area homeowner – and about \$9 million for Bill Gates. That should be plenty to help them relax while sipping Starbucks espresso and watching Grey's Anatomy or the Seahawks.

So, are we changing the old adage to "as Seattle goes, so goes the nation?" Well, maybe, but it won't be a straight road. With Seattle as anchor, the rest of the Pacific Northwest will also get a lift. Expect strong performance in Portland and Boise as well. Other strong contenders in 2006 will be those markets near or with some affinity to markets that have seen great housing wealth gains. Investors won big in Las Vegas and California and Phoenix in the recent past. These same investors will be sniffing around in Salt Lake City, Albuquerque, and Colorado. Similarly, the Florida housing boom will trickle upwards into the Carolina coast. Delaware and Virginia coast will get a lift from its proximity to high priced markets of Washington D.C., New Jersey, and New York. Maine and New Hampshire will see more purchasers from Massachusetts. Yes, the healthy housing market is still on the road – and making plenty of stops along the way.

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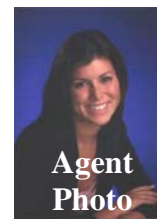
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