

# The State of the Housing Market in Metro Denver: Third Quarter 2006



October 26, 2006

# METRO DENVER HOUSING

## Introduction

The vitality and health of a region's residential market is a function of several factors such as employment and wages, population and net migration, residential construction activity, unsold inventory levels, and borrowing rates. Overbuilding in one or more categories can flood the new home market and lead to reduced sale prices in both the existing and new-home markets while negative net migration could short demand for housing and lead to lower sale prices and slowed sales overall.

Following the 2001 recession, the bullish residential market was key in the economic recovery of both the national and Metro Denver economies. Historically low interest rates, which prompted increased home sales and building activity nationwide, not only made home ownership more affordable but also allowed current homeowners to borrow against their existing loans and consequently prop up consumer spending. By 2006, residential markets across the nation began to show cracks with slowed home sales, receding appreciation rates, reduced building activity, and rising inventory levels of unsold homes. The current slowdown in the local and national residential markets are essentially market corrections, recognizing that various regions are experiencing unique conditions.

This paper takes an in-depth look at the current state of the housing market in Metro Denver and addresses the housing market situation from the perspective of two key questions:

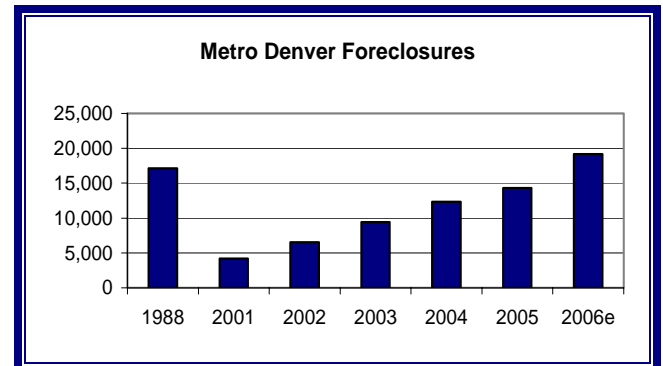
1. Why have foreclosures increased so dramatically in Metro Denver in recent years?
2. What is the impact of rising foreclosures?

This report first examines the foreclosure data for the region and then presents data suggesting how different factors are contributing to the foreclosure situation. Finally, the impacts on home construction and home prices are examined.

## Foreclosure Trends

Foreclosures are generally a lagging indicator in that a laid off worker, for example, will not be forced to foreclose immediately following termination. Typically, severance pay, savings, or other funding resources can stave off foreclosure until employment is reinstated. Generally, a household that is experiencing financial hardship will try to trim costs everywhere possible before lapsing in their mortgage payments.

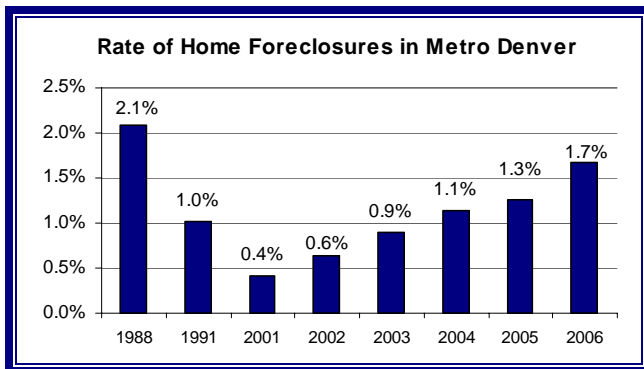
Residential foreclosures in Metro Denver are on pace to hit a record high in 2006. Through third quarter, a total of 14,132 foreclosure cases were opened in the seven-county region, which represents a 34.2% increase over foreclosure activity from the January-September period last year. At this rate, Metro Denver will record an estimated 19,200 foreclosure cases in 2006.



Source: CB Richard Ellis.

Opened foreclosure cases in Metro Denver are based on referrals from lenders or banks that the loan is in default. Not all of the opened foreclosure cases enter the final stage of foreclosure known as real-estate owned property or REO. A portion of the foreclosure cases reported by County Clerks in Metro Denver are "cured" or "withdrawn" if the owner makes good on delinquent payments or are "redeemed" if a third party purchases the property and subsequently satisfies the debt.

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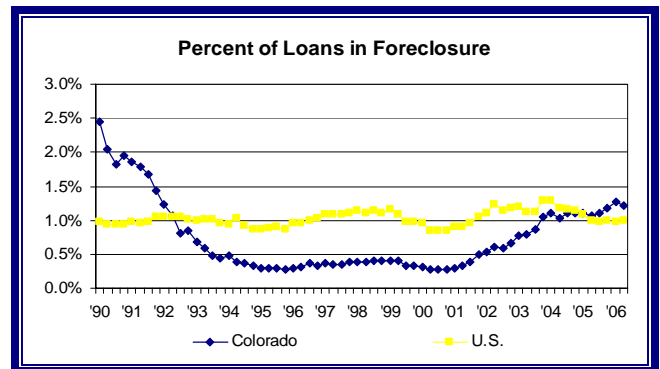


Sources: CB Richard Ellis; U.S. Census Bureau.

The rate of foreclosures based on the number of opened cases compared to the total number of housing units is estimated at 1.7% for 2006 compared to a rate of 2.1% in 1988 when 17,122 cases were opened. In other words, the current situation is not as drastic as in the late 1980s.

Three other data series describe the foreclosure situation in Colorado. It is important to note that these various data sources are not comparable with each other, but they do tend to reveal similar trends.

Data from the Mortgage Bankers Association compares the number of loans in foreclosure to the total number of mortgage loans. The percent of Colorado loans in foreclosure changed to below average in the third quarter of 1992 and remained below average until first quarter 2005. The U.S. reported a high so far this decade of 1.29% of total loans in foreclosure in both the fourth quarter of 2003 and the first quarter of 2004 compared to a Colorado high of 1.27% in the first quarter of 2006. Still, the 1.27% reported in the first quarter of the year is down from 2.45% reported in the first quarter of 1990. The percentage-point difference between the Colorado and U.S. rates is down from 1.5% in the second quarter of 1990 to only 0.2% in the second quarter of 2006, suggesting that Colorado is experiencing average foreclosure conditions compared to the late-1980s and early 1990s.



Source: Mortgage Bankers Association.

California-based RealtyTrac reports Colorado had the highest rate of foreclosure in the U.S. in September, a dubious distinction the state has held for seven consecutive months. September data reveals that one of every 408 Colorado households entered some stage of foreclosure in the ninth month of the year, a 26% decrease from the previous month but still 2.5 times above the national average of one of every 1,030 households in some stage of foreclosure. Nevada reported the second highest foreclosure rate in September, followed by Michigan, Florida, and Georgia.

A strong concentration of foreclosures in the Greeley Metropolitan Statistical Area (MSA), which is composed of Weld County, is propping up the statewide rate, according to new information from RealtyTrac. The Greeley MSA had the highest foreclosure rate for the second month in a row among the nation's 252 largest metropolitan areas in September. One of every 168 households in Weld County entered some stage of foreclosure in September, a rate six times the national average. The Detroit and Miami metropolitan areas documented the second and third highest metro foreclosure rates in the ninth month of the year.

Florida-based Foreclosure.com also tracks foreclosure data in the U.S. but uses a slightly different data set than RealtyTrac of just bank-owned properties in the final stage of foreclosure. Despite a 5.0% decrease in the number of Colorado foreclosures from July to August and an 11% drop

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from August 2005 to August 2006, Colorado had the highest foreclosure rate in the nation. National foreclosure decreased by 6.7% from July to August although new foreclosures were 7.3% higher in August 2006 than a year earlier.

## Reasons for Foreclosure

Why are foreclosures currently prevalent in Metro Denver and Colorado than in other parts of the country? While there may be numerous situations that lead to foreclosure, the following sections will explore five reasons that a household may move into a foreclosure position:

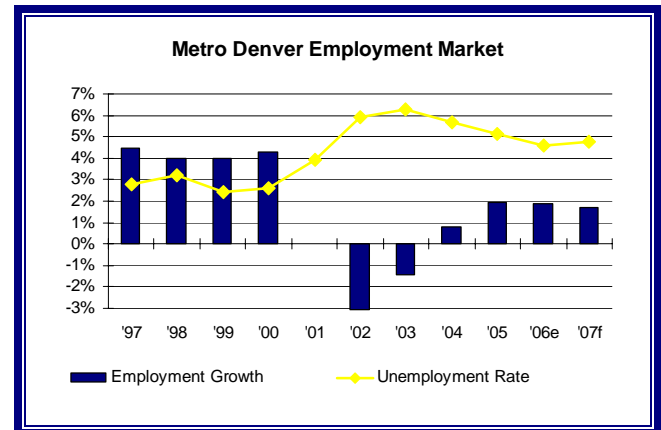
- ◆ **Employment:** Loss of job resulting in loss of wages.
- ◆ **Income:** Actual income growth less than expected income growth.
- ◆ **Inflation:** Increase in other household expenses.
- ◆ **Mortgage Fraud:** Discovery of decreased value of home or unexpected increased payments.
- ◆ **Mortgage Products:** Change in required mortgage payment due to type of mortgage product utilized.

## Employment

The strength of a region's employment market is arguably the most significant factor impacting its housing market. Typically, increased employment bodes well for the residential market in that workers earning paychecks are able to make housing payments whereas laid-off workers may be forced to forego current housing payments or downsize due to the lack of or reduced wages.

Employment growth in Metro Denver rebounded in 2004 with a 0.8% annual gain after declining in each of the two years prior. Employment growth strengthened in 2005 to a 2.0% increase but leveled-off to an expected gain of 1.9% in 2006 and 1.7% in 2007. On a positive note, total employment levels in Metro Denver surpassed pre-recession employment

levels in 2006 although annual growth rates remain more constrained compared to the late 1990s.



Source: Colorado Department of Labor and Employment.

The unemployment rate for the seven-county Metro Denver region has also improved in recent years from a high of 6.3% in 2003 to an average rate of 4.6% in 2006. The unemployment rate is expected to rise slightly in 2007 as a result of limited job growth.

The foreclosure activity experienced today may still be due, at least in part, to the employment situation that prevailed a couple of years ago. During Metro Denver's previous recessionary period in 1986-1987, 16,600 jobs were lost and unemployment peaked at 7.0%, representing 70,400 unemployed workers. Foreclosure activity peaked at 17,122 foreclosures in 1988, indicating the lag between job losses and foreclosure.

During the recent recessionary period in Metro Denver, 61,200 jobs were lost during 2002 and 2003. The unemployment rate peaked at 6.3% in 2003, representing 88,400 workers seeking new employment opportunities.

Although workers that were laid off in 2002 and 2003 may once again be employed, there is concern that some of these workers are experiencing underemployment. That is, the skills of some workers are underutilized in their current jobs. In the past few years, high-tech, computer hardware, and telecommunications companies in Metro Denver have undergone numerous changes that resulted in

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significant layoffs in these highly-paid positions. Theoretically, laid-off workers could have difficulty finding similar, high-paying jobs and may accept a lower-paying position. Underemployment of this kind is difficult to track and is not reflected in the unemployment rates reported above.

Laid-off employees that have been unable to find comparable employment may have succumbed to their growing household debt and may not be able to afford their current home. Even if they try to sell their home, soft existing and new home market conditions, including rising inventory levels, make it difficult for sellers to achieve their expected sale prices.

Given the severity of this current recession, it is not surprising that the lag period between loss of job and foreclosure was extended. However, recent job gains should start to temper the number of foreclosures.

## Income

A household's income determines how much home can be afforded. Stable or increasing wages and income ensure homeowners can continue to make current or larger mortgage payments. An unexpected change in income levels can lead to challenging situations.

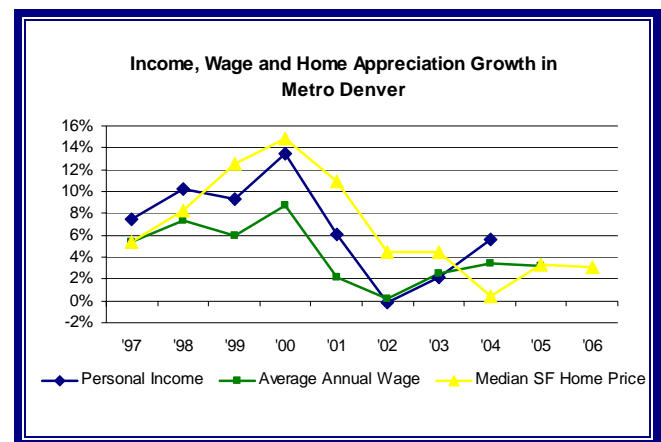
Metro Denver residents experienced a sharp slow down in annual per capita personal income growth so far this decade. The U.S. Bureau of Economic Analysis considers personal income to be salary and wages, dividends, interest, and rental-property income. Annual per capita personal income growth in Metro Denver slowed from 13.5% in 2000 to half that rate in 2001, followed by a 0.2% decline in 2002. Per capita personal income growth rebounded in 2003 and has grown at an increasing rate since. Despite slowed or negative personal income growth, Colorado had the eighth highest per capita personal income in the U.S. in 2005 at \$37,459.

The average annual wage in Metro Denver has also increased at a more moderate rate in recent years compared to pre-recessionary years, according to the Quarterly Census of Employment and Wages data

from the Colorado Department of Labor and Employment. From 2003 through 2005, the average annual wage increased between 2.8% and 3.5% each year compared to a 9.4% gain in 2000. On the bright side, the average first quarter wage in 2006 is up 9.9% over the first quarter wage earned in 2005.

Home price appreciation has outpaced average annual wage growth in Metro Denver since 1997, hitting an 8.8-percentage point differential in 2001. In 2005, the median single-family home price increased only 0.1% more than the average annual wage.

Per capita personal income growth has a more varied relationship with home price appreciation. Per capita personal income in Metro Denver grew at a faster pace than home price appreciation from 1996 through 1998 but home prices accelerated from 1999 through 2003. Per capita personal income again grew at a faster rate in 2004 and is expected to continue to do so for the next few years until the housing market in Metro Denver tightens.



Sources: U.S. Bureau of Economic Analysis, Colorado Department of Labor and Employment, and National Association of Realtors.

Other than income impacted by the overall employment situation, household income levels may also be impacted by various other factors such as a change in household status (unexpected births or deaths), divorce or separation, or injuries and accidents. These various household changes often

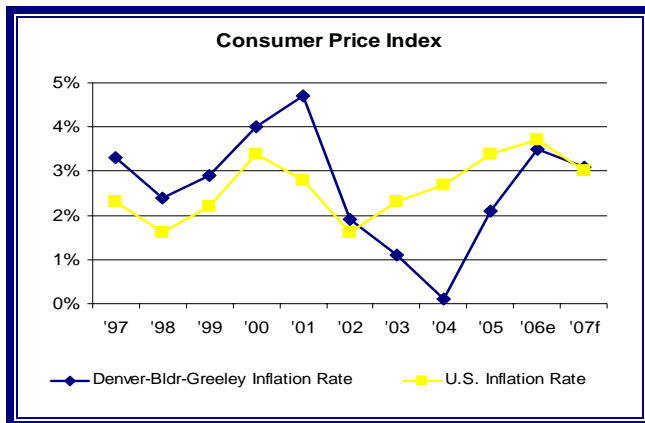
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result in financial hardship that may eventually lead to foreclosure.

## Inflation

Prices increased at a faster rate in Metro Denver than the nation from 1992 through 2002, according to the Consumer Price Index from the U.S. Department of Labor, Bureau of Labor Statistics. Metro Denver inflation then lagged the nation through 2006. Inflation dropped to a more than 20-year low of 0.1% in Metro Denver in 2004 but rose soon after due to a surge in energy prices.

The average price for a gallon of regular gasoline in Metro Denver increased to a record high of \$3.02 in September 2005. Heating prices also rose in 2005 in Metro Denver. For example, the average Xcel Energy heating bill in January 2005 was up 46% from a year earlier while the average October 2005 bill was up 49% from October 2004. Higher heating bills led to record delinquency rates in 2005, according to Xcel Energy.



Source: U.S. Bureau of Labor Statistics.

Inflationary pressure from rising energy prices may have constrained homeowner budgets in 2005, especially those homeowners on fixed budgets. Thus, homeowners unable to absorb surging energy prices may have been forced to foreclosure on their homes. Metro Denver inflation is expected to be on par with the U.S. in 2007 at an estimated 3.1%, down from 3.5% in 2006.

## Mortgage Fraud

Mortgage fraud may also be contributing to increasing foreclosures in Metro Denver and Colorado. Colorado was listed as one of the ten “hot spots” for mortgage fraud in 2004 by the FBI. Mortgage fraud has increased to a more than \$1 billion problem nationwide, more than double the \$429 million estimated in the year prior. The other top ten states for mortgage fraud in 2004 were California, Nevada, Utah, Arizona, Missouri, Illinois, Maryland, Georgia, and Florida.

Prior to the Mortgage Brokers Registration Act, which was passed in 2006 in Colorado, only Colorado and Alaska did not have such regulations in place for the mortgage industry. The new law requires brokers to register with the state, post \$25,000 bond, and to pass an FBI background check for fraud, deceit, theft, or similar offenses.

The number of violations of mortgage fraud suspicious activity reports (SARs) increased 578% from 2000 to 2005 in the U.S. Lenders issue SARs to the FBI if any part of the mortgage transaction is deemed suspicious. For example, a SAR may be issued if a borrower wrote a bad check with insufficient funds or if an appraiser falsely inflated the price of a home to gain a profit. Not all SARs are criminal in nature.

Locally, the Colorado Real Estate Commission is cracking down on “the most egregious cases” of appraisal fraud in Metro Denver. Erin Toll, the new director, is seeking record fines and license revocation of serious offenders. Criminal charges may also be instated if the offenders are turned over to the attorney general’s office.

Though not necessarily illegal, another troublesome factor is predatory lending which primarily affects senior citizens, low-income borrowers, and credit-challenged borrowers. Predatory lending forces borrowers to pay excessive settlement/loan origination fees, subprime or higher interest rates, or unreasonable service fees. Predatory lending can result in foreclosure or refinancing if borrowers are unable to make their payments.

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## Mortgage Products

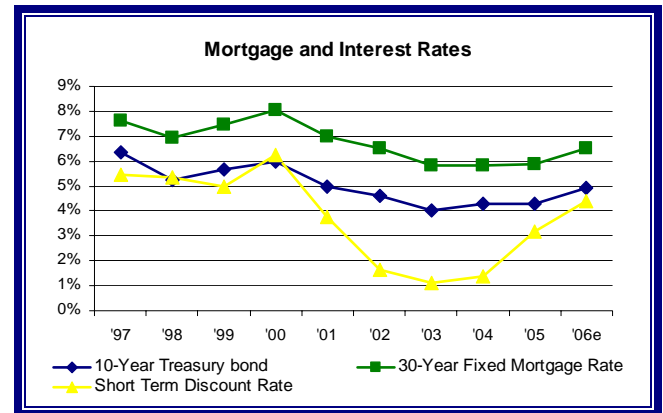
### *General Interest Rates*

Borrowing rates play an important role in the housing market from at least two different angles: prospective home buyers and residential developers. Prospective home buyers are typically enticed by decreasing or low mortgage rates as lower mortgage rates allow potential purchasers to buy more expensive homes and renter households to enter the ownership position. Lower mortgage rates also entice current homeowners to refinance at the lower rate, which allows homeowners to spend less on their home and more on other goods and services. On the other hand, residential developers pay attention to short-term interest rates, which are often necessary in funding development projects.

Long-term mortgage rates and long-term interest rates generally follow the same trend because they are both set by the market although long-term mortgage rates tend to be at higher levels than long-term interest rates. The relationship between long-term mortgage rates and the short-term discount rate can be more variable because the discount rate is set by the Federal Reserve and not the market.

The Federal Open Market Committee (FOMC) of the Federal Reserve paused its monetary tightening for the first time in more than two years at the August 2006 meeting and also left the target rate unchanged at 5.25% at the following meeting in September. Since June 2004, the FOMC increased the target rate 17 consecutive times from a low of 1.0%. Despite two years of persistent monetary tightening, mortgage rates and long-term interest rates have stayed relatively low. The 30-year fixed mortgage rate dropped to a low of 5.8% in both 2003 and 2004, stimulating the U.S. housing market. In 2005, the 30-year rate increased slightly and is expected to average about 6.5% in 2006. The 30-year mortgage rate peaked at 16.6% in 1981. As of the week of October 19<sup>th</sup>, the 30-year rate was 6.36%, up from 6.07% in October 2005. The five-year adjustable-rate mortgage (ARM) rate was

6.11% during the week of October 19<sup>th</sup> compared to 5.57% at this time last year.



Sources: St. Louis Federal Reserve Bank; Bankrate.com.

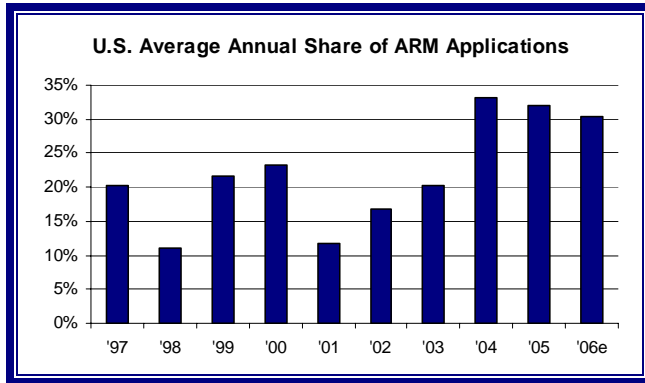
### *Adjustable Rate Mortgages*

The stable and relatively low long-term mortgage rates in combination with ARMs and new mortgage products such as no-interest loans and option ARMs have helped ease entry into home ownership although the newer mortgage products can be troublesome in certain cases. For example, option ARMs are among the most complex and confusing loans for consumers to understand. Option ARMs effectively result in negative amortization when borrowers utilize the minimum payment option which adds interest payments to principle. About 6.4% of the loans issued in Colorado during the first half of 2006 were option ARMs compared to 10% of the loans issued nationwide, according to California-based Loan Performance.

In general, analysts consider ARM loans to be riskier than traditional 30-year loans because of the variable nature of interest rates after the established fixed period. The share of ARM applications nationwide has slipped from the 2004 peak of 33% to 26% in August 2006 as more borrowers take advantage of still historically low rates and convert existing ARMs to traditional fixed-rate mortgages. The average share of mortgage applications for refinancing hit 65% in 2003, up from 24% in 2000. By 2005, the average share of applications for

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refinancing had declined to 44% and currently stands at 42% through August 2006.



Source: Freddie Mac.

ARM loans account for a higher than average percent of total loans in Colorado. In the second quarter of 2006, ARM loans represented 28.6% of the total Colorado loans serviced compared to 21.3% at the national level. Of the nearly 280,000 ARM loans serviced during the second quarter of 2006 in Colorado, 36.4% were subprime or FHA loans, slightly higher than the U.S. average of 34.4%.

ARMs represent a disproportionate share of the total number of foreclosures. In the second quarter of 2006, 52.5% of the loans in foreclosure in Colorado were ARMs compared to 35.7% of the loans in foreclosure nationally.

## *Subprime Loans*

In the second quarter of 2006, subprime loans accounted for 12.9% of total loans in Colorado. Subprime mortgage loans are typically made to borrowers with high-risk credit as determined by credit history or the current amount of debt carried by the borrower. Lenders compensate for the high-credit risk by charging higher interest rates and fees compared to the interest rates and fees associated with a prime loan. Many subprime loans are used for home equity loans as opposed to the purchase of a home.

In Colorado, 41.2% of the total loans in foreclosure in the second quarter of 2006 were subprime, about the same as the national level. Of the total past due

loans in second quarter 2006, 34.6% were subprime loans in Colorado compared to 35.8% in the U.S. Colorado ranked 21st for the percentage of subprime and delinquent loans. Rhode Island (50.2%), California (48.7%), and Nevada (47.2%) had the highest percentage of subprime delinquent loans.

## **Impacts on the Housing Market**

Rising foreclosures have multiple impacts on both the existing and new home market, as well as on both the for-sale and rental markets. The following sections explore the current state of these various segments of the housing market.

On a positive note, low interest rates have helped more Metro Denver residents become homeowners than ever before. About 72% of occupied housing units in Metro Denver are owner-occupied in 2005, according to the *U.S. Census Bureau*. About 66% of occupied homes in Metro Denver were owner-occupied in 2000, up from 62% in 1990. Local home-ownership rates exceed the national average of 67% in 2005, up from 66% in 2006.

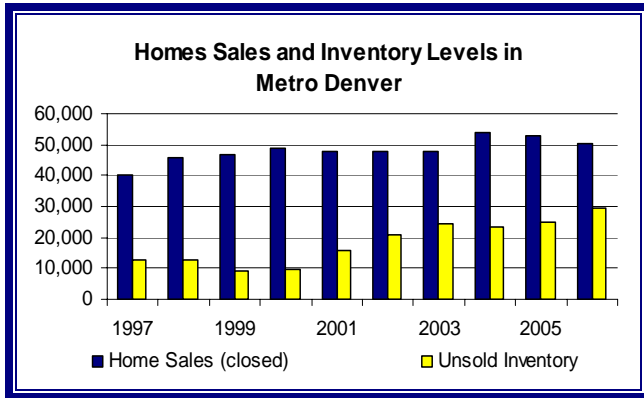
## **Existing Residential Market**

There is no question that the existing housing market in Metro Denver has weakened in recent months; however, this slowdown follows two years of the most robust sales in Metro Denver history. Now, total existing homes sales are down 5.0% through third quarter 2006 compared to the same period last year. More specifically, existing single-family home sales are down 5.0% and condominium sales are down 4.8%.

Slowing home sales have coincided with rising inventory levels of unsold homes in 2005 and 2006 after moving in opposite directions in 2004. Inventory levels peaked in July 2006 at nearly 32,000 unsold homes in the Metro Denver region and September 2006 inventory levels were 15.4% higher than a year earlier. Consequently, the average number of days Metro Denver homes have been on the market is also tracking higher in 2006 than in 2005. Through September, Metro Denver homes

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have sat on the market an average of 101 days compared to 90 days last year 2005.



Source: MetroList, Inc.

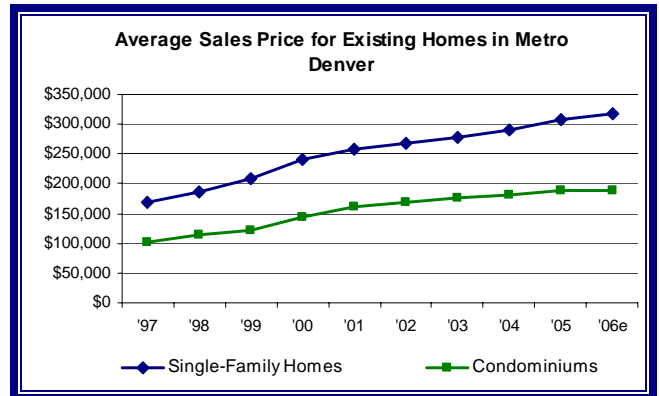
Nationally, existing home sales have cooled as well. In August, the National Association of Realtors reported that seasonally-adjusted homes sales decreased 0.5% from July to August, bringing the annualized pace down to 6.3 million units. August home sales were down 12.6% from a year earlier with both the single-family and condominium categories reporting decreased home sales over the 12-month period. The nation's supply of homes on the market is up to 7.5 months, the highest level since April 1993.

Meanwhile, home price appreciation has slowed in Metro Denver, according to MetroList data. The average sales price for single-family homes in Metro Denver trended upward at an increasing rate in both 2004 and 2005 but has slowed so far this year. The average sales price for a single-family home is up 3.7% through the first three quarters of 2006 compared to a 6.1% annual gain in 2005.

Furthermore, the average single-family home sales price peaked at \$261,750 in June 2006 but decreased to \$243,500 only three months later. On a year-to-date basis, the average sales price in the single-family category is \$318,500.

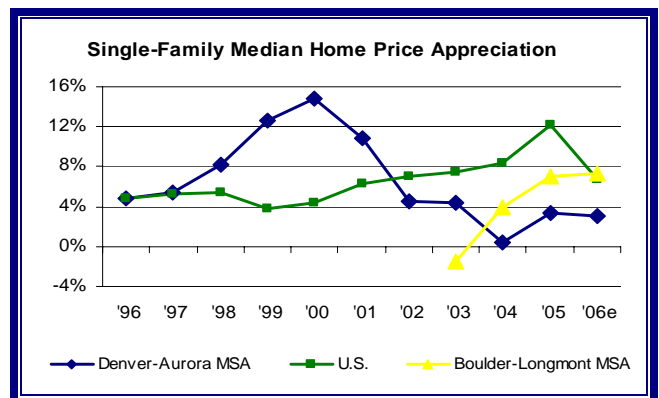
Condominium sales prices are down 0.5% so far this year compared to a 4.4% annual gain achieved in 2005. The average sales price peaked at \$199,000 in August 2005 and has since declined to \$191,000 in

September 2006. On a year-to-date basis, the average sales price in the condominium category is \$188,700.



Source: MetroList, Inc.

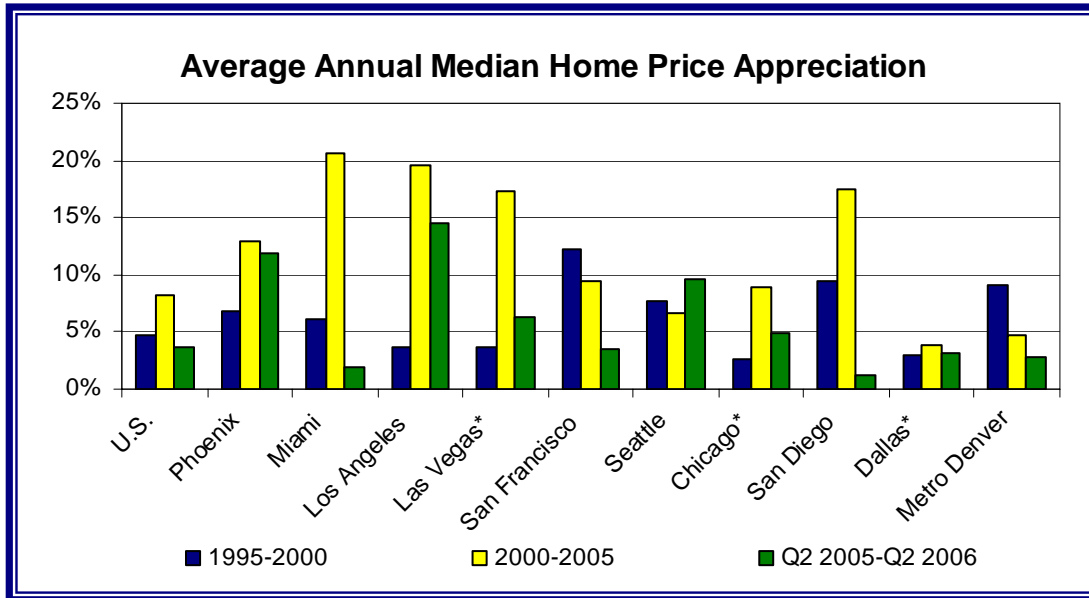
A separate data series from the National Association of Realtors reveals similar results for median home price appreciation in Metro Denver. Through June 2006, the median single-family home price in the Denver-Aurora MSA was 3.1% above the median price in the first half of 2005. The Boulder-Longmont MSA experienced a 7.3% gain over the same period compared to a 6.8% gain for the U.S.



Source: National Association of Home Builders.

Median home prices in Metro Denver have actually been appreciating at a slower than average rate since 2001 when Metro Denver home price appreciation of 10.9% outpaced the nation's 6.3% increase. From 1999 through 2001, Metro Denver home prices grew at double-digit rates.

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Source: National Association of Realtors.  
 Note: \*1997-2000 average annual growth rate due to data availability.

The double-digit appreciation of the late 1990s and early part of the current decade is no longer the case in Metro Denver. Although homeowners may not make as large of a profit off their home, moderate appreciation is more favorable for the overall economy. Workers are able to afford housing if their wages keep pace with home appreciation and more moderate appreciation creates a stable development environment as opposed to encouraging speculative development or a boom that will only make the inevitable decline deeper and longer.

Other metropolitan areas are currently experiencing or have recently experienced double-digit appreciation in the single-family category. As a result, some of these metropolitan areas face an inevitable price correction. These metropolitan areas also risk pricing the workforce out of the market and losing a competitive advantage of attainable home prices which is important in the attraction of companies and residents.

Metro Denver posted an average annual home appreciation rate of 9.1% from 1995 to 2000, one of the strongest rates in the country. The average annual appreciation rate in Metro Denver dropped to just under 5% during the 2000-2005, a time when many competitor locations experienced major

housing booms. The rate of appreciation across the country is moderating in 2006, although Metro Denver is still performing at a level slightly below the national average.

The median single-family home price more than doubled in sixteen metropolitan areas in the U.S. from 2000 to 2005, including a 170% increase in Riverside/San Bernardino metro area, a 159% increase in the Sacramento metro area, and a 156% increase in the Miami metro area. By contrast, the Denver-Aurora MSA posted a 26% gain or an average annual gain of 4%. National appreciation posted an average annual increase of 8% over the same period for a 58% overall gain. Data prior to 2003 is not available for the Boulder-Longmont market.

From 2004 to 2005 alone, 69 metropolitan areas reported double-digit gains, including a 46% increase in Phoenix/Mesa/Scottsdale, a 29% increase in Miami, an 18.5% increase in the Los Angeles metro area, and a 14.4% increase in the Las Vegas metro area.

Thirty-seven metropolitan areas reported double-digit appreciation from second quarter 2005 to second quarter 2006, including five Florida

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metropolitan areas that placed among the top 11. Other existing residential markets that have yet to see a slowdown are the Los Angeles and Phoenix metropolitan areas with respective quarter-over-quarter gains of 14.6% and 11.8 %.

Conversely, thirty-six metropolitan areas reported negative or less than one-percentage point appreciation from second quarter 2005 to second quarter 2006, including the 0.4% increase in the San Jose metropolitan area. Growth has also slowed somewhat in the Miami, San Diego, San Francisco, and Washington, DC regions. The Denver-Aurora region ranked 96<sup>th</sup> out of the 150 largest metro areas for second quarter to second quarter growth while Boulder-Longmont ranked 54<sup>th</sup>.

According to the latest Risk Index from the PMI Mortgage Insurance Co., which measures the risk of home price declines two years out, Metro Denver is better off than more than half of the nation's largest metropolitan areas. The Denver-Aurora MSA has an 18.7% chance of a home price decline in the next two years compared to an average risk of 32.8% for the 50 largest metropolitan areas, ranking the Denver-Aurora MSA 29<sup>th</sup> among the 50 largest metropolitan areas. Metro Denver fares better than the 18 metropolitan areas that have a 50% or higher chance of price declines, including Las Vegas, Miami, eight metropolitan areas in California, and eastern seaboard cities like Boston, Cambridge, and New York.

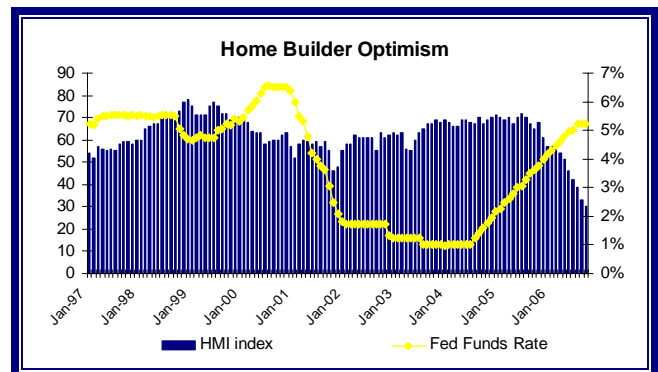
Similar to the equity markets, there is a “wealth effect” associated with home values and prices in that consumer spending may be negatively impacted if a homeowner's perceived home value declines. Metro Denver homeowners will not be subject to this “wealth effect” from the stable yet modest home appreciation of late whereas other metropolitan areas that experience actual price declines have the potential to realize this “wealth effect.”

## New Residential Market

Interest rates also impact the supply-side of the housing market in that developers typically finance residential projects with short-term loans. The

historically low, short-term borrowing rates of 2002-2004 likely stimulated residential construction among other factors. Short-term interest rates (based on the federal funds rate) increased in 2005 and 2006 but still remain below the overall historic average of 5.75% (07/1954-08/2006). Through September of 2006, the average federal funds rate was 4.87%. The National Association of Home Builders (NAHB) is forecasting the federal funds rate will stay in the 5.0% to 5.1% range from 2006 through 2008.

The inverse relationship between residential development and short-term interest rates can be illustrated with homebuilder sentiment levels. Home builder sentiment across the U.S. dropped to the lowest level in September 2006 since February 1991, according to the NAHB/Wells Fargo Housing Market Index. Home builder optimism has declined as the Federal Reserve consistently increased the target for the short-term federal funds rate.



Sources: National Association of Home Builders/Wells Fargo; St. Louis Federal Reserve Bank.

Similar to the existing market, new home sales in Metro Denver are also down compared to last year. The Genesis Group reports that new home sales in the first half of 2006 were down 11.3% in Metro Denver compared to the same six-month period in 2005 with only the City and County of Denver and the Northwest submarket reporting respective year-to-date increases of 14.2% and 1.6%. Attached home sales through second quarter 2006 are up 2.1% over 2005 compared to an 18.3% decline in detached home sales. The Genesis Group notes that the first

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half of 2006 marks the first time since 1999 that total detached home sales have dipped below the 6,000-sales mark. Additional data from the Genesis Group indicates increased supply of new homes on the Metro Denver market. Total new home inventory levels were 16.3% higher during the first half of the year compared the same six-month period in 2005. The 16.3% gain is a result of a 37.0% increase in the number of available detached homes on the market and a 2.6% increase in the number of attached homes.

Meanwhile, home prices continued to climb in the first half of the year despite declining sales. The average sale price for a new detached home during the January-June period was \$340,900, a 9.4% gain over the average price last year. New attached homes saw a 47.8% increase to \$331,000, largely in part to a surge of luxury condominiums and lofts in Downtown Denver and higher-end transit-oriented development and mixed-use projects along the southern I-25 corridor.

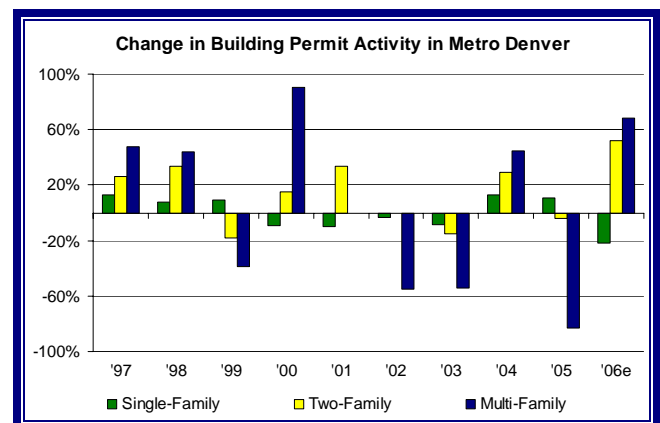
The national new-home market is also reporting softer conditions in 2006. Sales of new homes in the U.S. increased 4.1% from July to August to a seasonally adjusted annual rate of 1.05 million units but August sales were still down 17.4% from a year earlier. In the West region, new home sales declined 17.6% from July to August and were down a staggering 34.7% from August 2005. Only the Northeast region is reporting an increase in year-over-year sales. The U.S. supply of new homes on the market was 6.6 months at the sales pace set in August 2006, up from 4.6 months in August 2005.

Home prices are moving in varied directions at the national level. The median sales price of new homes in August 2006 was \$237,000, down slightly from \$240,100 in August 2005. The average sales price in August 2006 of \$304,000 was up 3.2% from the average sales price of \$295,000 a year earlier.

Metro Denver homebuilders have recognized the softening market conditions and pulled back accordingly on residential construction. Compared to the first eight months of 2005, the total number of

single-family building permits issued in Metro Denver is down 7.1%. Single-family detached permits are down 22% at 8,466 through August while single-family attached permits are up 52% at 4,153. Still, the overall pullback in single-family construction in 2005 follows the highest level of construction activity since 1999. Multifamily or apartment construction activity, on the other hand, is up 68.2% through 2006, although only 459 multi-family permits were issued in 2005, which was the lowest level in fifteen years.

Aurora is the most active community so far this year for single-family detached building with 1,558 permits. Denver and Castle Rock followed with 971 permits and 782 permits, respectively. Denver has issued the most permits this year for single-family attached homes at 1,479 permits. Unincorporated Douglas County (411), Aurora (351), and Broomfield (331) are the only other communities with greater than 300 permits issued. Lakewood, Arvada, and unincorporated Douglas County are the only communities reporting any multi-family construction activity in 2006.



Source: Home Builders Association of Metropolitan Denver.

The National Association of Home Builders (NAHB) expects housing starts to pull back from the 2.1 million units in 2005 to 1.84 million units in 2006, 1.62 million units in 2007 and 1.73 million units in 2008. Multi-family construction will remain relatively stable while single-family construction

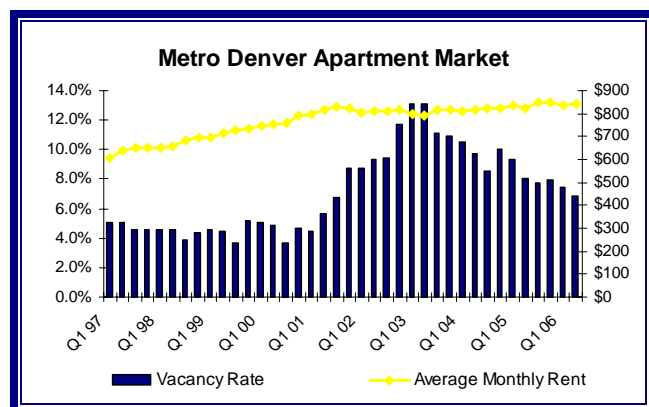
# METRO DENVER HOUSING

will see more noticeable reductions in the 2006-2008 period.

## Rental Market

The rental market in Metro Denver has steadily improved since mid-2003 with declining vacancy rates and modest increases in rents. The historic low interest rates in recent years allowed renters to move into an ownership position over the last few years, pushing rental vacancy rates to a high of 13.1% in the second and third quarters of 2003. Vacancy rates began to taper off as the Federal Reserve instituted 17 consecutive rate hikes from June 2004 through mid-2006. Today's higher interest rates have likely caused a portion of homeowners to default on ARM loans and return to a renter position while other current renters have decided to continue renting and hold off on purchasing a home. The average vacancy rate for the Metro Denver apartment market improved from 12.0% in 2003 to 9.7% in 2004 and 8.2% in 2005. Through the first half of 2006, the average vacancy rate is 7.2%.

Landlords coped with the soft market conditions by offering deep concessions which are still prevalent today but not as pervasive. The average rental rate declined 0.9% in 2002 and was flat in 2003. In 2004, the average rental rate rebounded with a 0.9% annual gain, followed by an even stronger 3.2% increase in 2005. Through mid-2006, the average rental rate is up 1.1% compared to the first half of 2005.

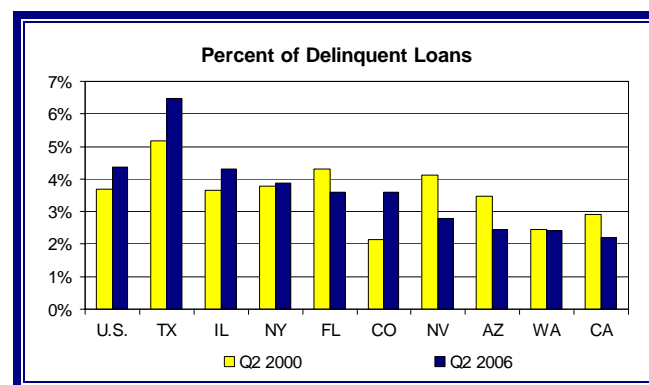


Source: Denver Metro Apartment Rent and Vacancy Survey.

## What is Ahead for the Metro Denver Housing Market?

To end on a positive note, recent delinquent loan data from the Mortgage Bankers Association suggests Colorado homeowners may have turned a corner or are at least approaching a turning point in the foreclosure dilemma. The percentage of Colorado home loans serviced in second quarter 2006 that had delinquent payments of 30 to 90 days was lower than average. Colorado ranked 28<sup>th</sup> for the percentage of home loans with any past due installments in the second quarter of the year with 3.6% delinquent loans compared to the U.S. average of 4.4%. More specifically, Colorado ranked 35<sup>th</sup> in the nation for loans with past due installments of 30 days.

The lower than average delinquency rate hints that fewer Colorado homeowners are struggling with mortgage payments and suggests that Colorado's foreclosures may be cooling. Still, foreclosures in Colorado are not expected to drop off quickly. Colorado ranked 19<sup>th</sup> in the nation for the percentage of loans that were "seriously delinquent" in the second quarter of 2006. Seriously delinquent is defined as the non-seasonally adjusted percentage of loans that are 90 days or more delinquent or in the process of foreclosure.



Source: Mortgage Bankers Association.

# METRO DENVER HOUSING

## The Good, The Bad, & The Ugly

There are positives and negatives to the current housing situation in Metro Denver, especially from an economist's perspective.

### *The Good*

- ◆ Employment growth in Metro Denver is solid at 1.9% in 2006 and 1.7% in 2007.
- ◆ Personal income is expected to increase in Metro Denver partly due to a strong stock market.
- ◆ Pressures from energy prices and overall inflation will ease somewhat in 2007.
- ◆ Interest rates are steady and expected to be contained due to reduced inflationary pressure.
- ◆ More industry controls for the mortgage and appraisal industry are in place in Colorado.
- ◆ Homebuilders have pulled back on construction.
- ◆ Population growth of 1.6% in 2006 reflects continued interest in the region.
- ◆ Modest home appreciation rates but reduced risk of falling prices compared to other metro areas.
- ◆ Strengthening rental housing market.

### *The Bad*

- ◆ Builder confidence is down due to reduced construction activity.
- ◆ Employment growth is expected to be slightly slower than in 2006 although at a sustainable rate.
- ◆ Wage growth is stable but has not yet returned to pre-recessionary levels.

### *The Ugly*

- ◆ Foreclosures are likely to remain high in Metro Denver and Colorado although at a reduced level.
- ◆ High inventory levels in both the new home and existing home markets will remain for awhile.

The national downturn, which is considered more of a “breather” than a slump according to some national housing analysts, is a product of mixed results across the nation. Some housing markets continue to expand while others are in a state of stability or contraction. In general, Metro Denver's housing market currently falls into the stable category barring conditions do not worsen.

The local Metro Denver housing market will likely post soft conditions for the remainder of 2006 and throughout 2007. We expect existing home sales to moderate again in 2007 along with stable home price appreciation of between 3.0% and 5.0%. Inventory levels will continue to be at high levels in 2007 although total foreclosures are expected to decline slightly. Developers will remain guarded about new residential projects especially in the single-family market until overall inventory levels decline. The apartment market stands as a beneficiary of high foreclosures in that vacancy rates are expected to continue to decline while average monthly rents increase.



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