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Is There a Bubble in Southern California Housing Market?

Recently, much media attention has focused on housing prices and a possible bubble in the housing market. A housing bubble is an unsustainable run-up in prices that is based on unrealistic values, and irrational and exuberant speculation. Buyers believe that even though prices are exorbitant, housing prices will continue to increase. Speculators buy with the hope of flipping the house at a higher price in the near future. First time buyers buy for fear of being permanently locked out of the housing market by further price increases.

Bubbles are usually followed by a market downturn and a collapse in prices. Prices need not fall dramatically but merely stagnate or trend down over several years. When the bubble bursts, employment, incomes, and economic activity in an entire region can be adversely affected.

Is there a housing bubble in Southern California and if so, when will it burst? Although the run up of prices has been a national (and worldwide) phenomenon, some areas have experienced greater price increases and more bubble tendencies than others. Southern California is one of those areas with a great deal of “froth” and record price increases in recent years.

Many analysts believe that the Southern California housing market is poised for a downturn which would adversely affect the entire economy. Research at Chapman University in Orange California and UCLA point to similarities in today’s housing markets and the ones in 2006.

In early 2005, UCLA forecasted a slowdown in the housing market starting by mid 2005. In late 2005, UCLA forecasted a plateau in home prices, a decrease in sales and new building, and two years of weak growth leading to declines in the construction and home finance industries. Chapman University had forecasted slowing housing appreciation in California in 2003 and 2004 and actual decreases in 2005. At the time, the hot California housing market proved those forecasts to be wrong. The median home price in California was rising in double digits since 2003 and hit $452,000 in January 2006, up 13 percent for the same period a year ago. The housing market peaked in early 2006. By mid 2006 signs of trouble started to be seen when subprime loans started to go into default.

In considering whether or not there is a housing bubble and the likelihood that it will burst, one needs to consider both the demand and supply factors for housing. On the demand side, the three primary factors fueling the Southern California run-up in housing prices are population growth, low interest rates, and affordability due to favorable economic conditions. On the supply side, the amount of land is fixed and many prime areas of Southern California are built out with the only option being to build up or move out.

The econometric model used in this study will be applied to time-series data for Los Angeles County, Orange County, San Bernardino/Riverside Counties and Southern California as an aggregate. We use an aggregate model of Southern California and disaggregate models of counties as our preliminary study shows that a one percent increase in mortgage rate decreases median housing prices in diffrenet counties at different rates and a one percent increase in population increases median housing prices at different rates in different counties. While mortgage rates have been inching up gradually, the migration of households seeking affordable housing results in a different average annual population growth in counties with growth being higher at Riverside and San Bernardino Counties than Los angeles and Orange counties.

In terms of affordability, while the affordability index (a measure of the percent of households who can afford to purchase a median-priced house) in California has been dropping, the housing affordability index for San Bernardino/ Riverside counties stood significantly higher than that of California.