

Price-to-Income Ratios Offer Insights

Understanding this market metric could help brokers make better decisions at local levels

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WITH PLUMMETING HOME values playing a large role in the current recession, everyone from individual homeowners to real estate professionals has a keen interest in what might happen to home prices going forward. For residential mortgage brokers, the question is particularly important, both in terms of marketing to new clients and underwriting loans.

Any analysis of the housing market should consider a combination of demographic, economic, pricing, and supply-and-demand variables to estimate future performance. One key metric is the relationship between median home prices and median household incomes — the price-to-income ratio (PIR) — at national and local levels.

Understanding the relationship between prices and incomes, along with other variables, may help inform a forecast for the pace and magnitude of continued price declines, as well as an eventual housing-market recovery. Having this understanding also can help brokers better plan when to ramp up their business efforts in specific markets.

Prices past and present

Historically, home-price gains have closely mirrored household-income gains, both nationally and across individual metropolitan areas. This relationship is evident in the correlation between prices and incomes at the national level from 1970 through 2000 (see chart “Change in Median Home Price Vs. Median Household Income”).

The froth in home prices that began around 2001 is evident in the large gap that developed

between incomes and prices. It appears that the sharp rise in home prices in the early years of this decade resulted from a variety of factors besides income growth — including historically low mortgage rates; a downturn in other asset classes that encouraged investment in real estate; and the proliferation of subprime (aka, nonprime) lending and other financing options that removed some of the historic hurdles to homeownership and encouraged speculation in the housing market.

Recently, falling prices have helped narrow

to housing. Research suggests a variety of reasons for the variations, including a combination of economic and demographic conditions (e.g., productivity, in-migration and out-migration), amenities (e.g., weather and environmental conditions), and supply constraints.

On a market level, PIRs have varied through time, affecting relative affordability and volatility in individual markets. According to research data, the median home price in Los Angeles, for example, historically averaged nearly five times the median household income and reached a

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this gap. But with incomes expected to stagnate or decline in response to various economic pressures, home prices will need to continue to fall before a more typical relationship between price and income returns.

Despite the direct relationship at the national level, the relationship between price and income varies significantly by metropolitan area, with housing in some cities consistently more expensive relative to local incomes. Looking at the PIR in a number of U.S. metropolitan areas relative to the national figure at the end of 2008 (see chart “Regional Affordability Comparison”), some areas tend to be more expensive, with households allocating a larger portion of income

peak of more than 10 times the median household income in the first quarter of 2007. The median home price in Phoenix, on the other hand, historically averaged less than three times the median household income and peaked at just more than five times the median household income in the first quarter of 2006.

Different market stories

Of five Southwest metros studied — Los Angeles; Phoenix; San Diego; Orange County, Calif.; and Riverside, Calif. — only Phoenix was historically more affordable than the U.S. average, dating from the early 1980s. In Phoenix and in Riverside, the second-most affordable area historically, the rapid acceleration of prices relative to incomes eventually pushed the PIR above the national figure.

Elsewhere, metropolitan areas in Florida are notable for their generally lower PIRs. Of five Florida cities studied — Fort Lauderdale, Jacksonville, Miami, Orlando and West Palm

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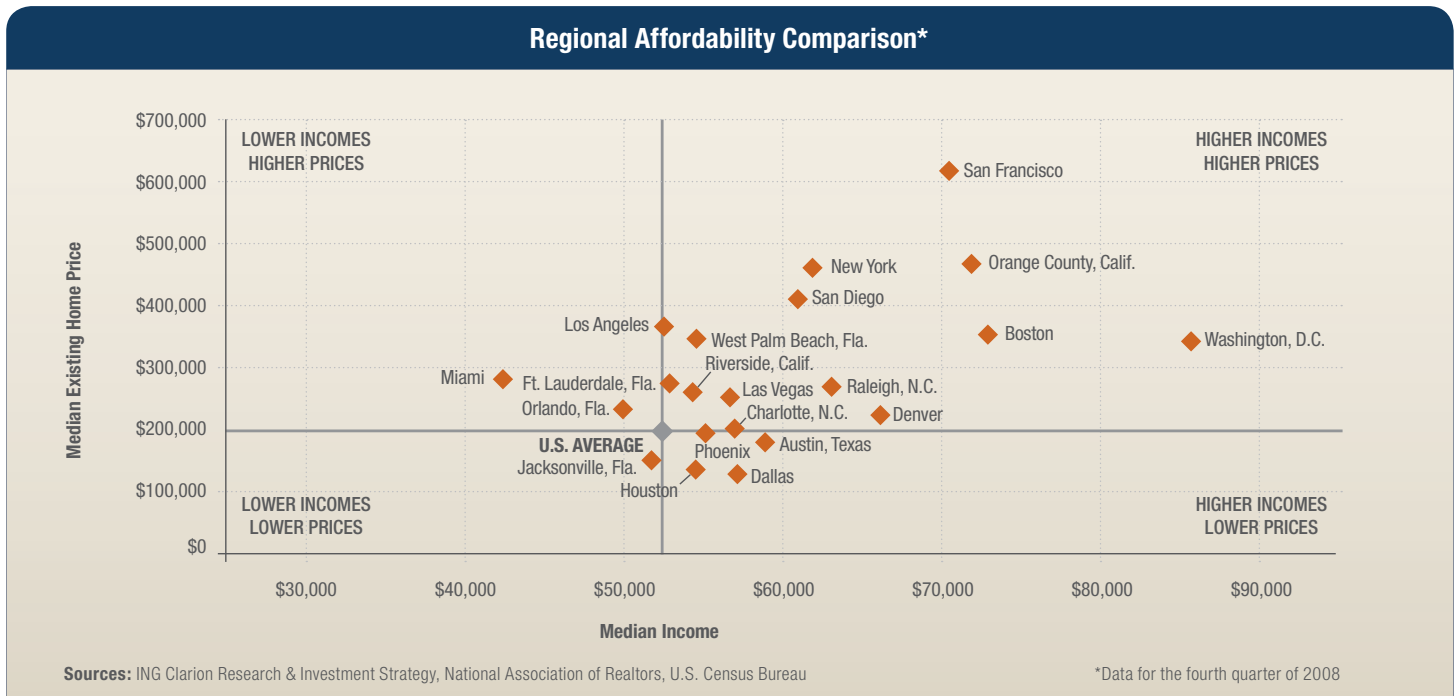
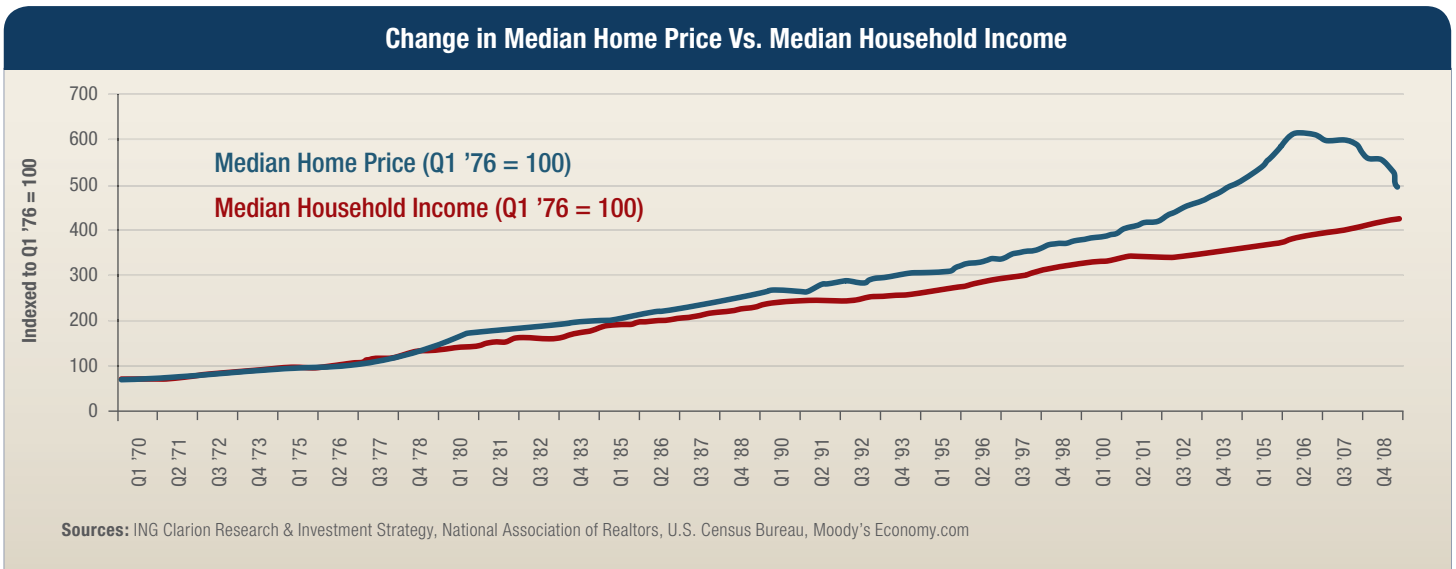
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Beach — all except for West Palm Beach had long-term-average PIRs below the U.S. average. Historically, with West Palm Beach again the exception, these Florida markets have been less volatile than Southwest markets. Prices showed relatively steady growth until the boom that began around 2000. Most of the Southwest markets, on the other hand, also saw large price swings in the 1980s and 1990s.

Spreads between long-term-average PIRs

and current PIRs suggest one measure of the potential additional price adjustments necessary to return balance to the housing market. Areas more in concert with historic PIRs should generally be expected to hit a pricing trough earlier than markets where the relationship remains skewed. Because of the earlier start to the housing downturn in the Southwest, those markets appear closer to reaching sustainable PIRs than Florida markets.



While there has been considerable discussion recently about positive signs in the housing market, PIR indicators show that national median home prices will continue to decline, though at a slower rate, into the last quarter of this year.

Understanding how prices and incomes relate may help mortgage brokers time their activity and plan for the developments of the next six months and beyond. **!**