Will L.A.'s Real Estate Bubble Burst?

No, Because There Isn't One. There's Just Too Much Demand, Not Enough Supply and No Room to Build. None of That Will Change.

By Eryn Brown
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"Let's start here," Ross Novie says, as he steers his Honda onto Federal Avenue. He and his wife Agnes want to buy a home. It's Sunday. They're trolling the open houses.

Between them, the Novies bring in more than $100,000 a year, which puts them in the top fifth of wage earners in California. They're looking to spend around $450,000, and they're hoping to stay on the Westside, near Ross' job as an assistant director on the Fox TV comedy "Arrested Development." The couple are prepared to buy a house that needs some TLC, but any renovation work will have to be finished by the spring, when Agnes, 36, gives birth to their first child.

"People say you have to have reasonable expectations," 32-year-old Ross says. "I think we do."

They drive south and east through West L.A., past rows of low-slung stucco houses, some well-kept, others shabby. Ross occasionally peeks at a page he has torn out from the newspaper, with three or four ads circled. But before they reach any of those houses, he spots a sign. It's on Granville Avenue, north of National Boulevard, in front of a smallish, nondescript house. "Ah!" he says. "I do get a kind of bitter joy when I see an open house sign." He pulls over.

"It'll be $500,000," he says as he climbs out of the car.

"$650,000!" bets Agnes.

Just inside the entryway they find a flier. The owner wants $699,000. Agnes rolls her eyes. Ross takes about a millisecond to look around the house. It is freshly painted and has hardwood floors and built-in shelves. "This is nice," he says. "But this is for wealthy people."

They turn and walk back out the front door. A small plane, following the flight path into Santa Monica Airport, buzzes the little house. It sounds like a dive-bomber closing in.

Everyone knows that the housing market in Southern California has gone, if you'll pardon the pun, through the roof. As of August (the most recent figures available), according to the California Assn. of Realtors, the median price of a home in Southern California was up sharply from last year:

- Los Angeles County: up 24%, from $300,980 to $374,720
- Riverside and San Bernardino counties: 28% to $ 231,300 (numbers from July)
- Orange County, 20% to $523,600
- Santa Barbara County: 18% to $479,540
- San Diego County, 17% to $444,230

Since 1969, home prices in California have appreciated an average of 8.3% per year. These days, they can go up almost that much in a month. It's not uncommon to hear of houses—modest houses, like the ones the Novies are checking out—selling for $25,000 to $50,000 more than they would have just days before.

The reason is simple: Record-low interest rates are attracting buyers in record numbers, and there's much more demand than supply. It's a seller's market—perhaps like never before seen in Southern California. And no one knows when, or if, it will let up.

The price increases have been a bonanza for the half of Los Angeles County residents who already own their homes and who've watched the value of their property, and the equity they hold in it, soar. The same is true, though less dramatically, in many parts of the country. Economists say it's the strength of the real estate market that has helped pull the U.S. economy out of its doldrums—that by refinancing their rapidly appreciating homes, people have been able to buy all those recession-busting SUVs, granite countertops, flat-screen TVs and designer jeans. The real estate boom has, by and large, been a godsend for middle-class America.

But there's a dark side. For every happy household enjoying the fruits of the boom in Southern California, there's another that's been priced out of moving into the bigger house it needs, and yet another that's having trouble breaking into the housing market at all. Nationwide, 56% of people can afford to buy a median-priced home in the communities where they live. But only 24% of Los Angeles residents could afford to, as of August, according to the Realtors association. The minimum household income required to buy a median-priced home in California—based on a 30-year, fixed-rate mortgage with a 20% down payment—is now a whopping $93,490. Only 21% of California households earn that much.

Obviously, the problem is most dire for people in the lowest income brackets—who struggle to put a roof over their heads, much less find a home to buy. But it's also hard for middle-class families to own their piece of the American Dream. These days affordability is a problem for single people and married people, for young people and old people, for black people and white people, for first-time buyers looking for $150,000 condos and for longtime homeowners looking in the million-dollar range.

According to the Realtors association, sales of existing single-family homes in the state hit a record 645,720 in August, but the percentage of first-time buyers has been steadily declining since 1995, when it was more than 50%. It is currently 30%.

The affordability crunch is raising all kinds of questions about the squishier side of homeownership: personal style, hopes and dreams. A home is, after all, more than an investment. It's a dwelling. It's an artistic expression. It's you. In vast Los Angeles, the cradle of the postwar suburban lifestyle, that kind of stuff is supposed to matter. But maybe it can't anymore.

"People just moan and groan that they can't afford anything, but when you ask them about it, you realize they can—they just don't want to live where they can afford," says John Karevoll, an analyst at DataQuick, a real estate research firm in La Jolla. "But this is an exercise in managing expectations. That's what entry-level buying is."

Karevoll has a point. People such as Ross and Agnes Novie surely could find a house more easily if they looked in the Inland Empire or the Santa Clarita Valley. The question is, should they have to? Is it now unrealistic for six-figure-earning professionals to build some equity and still be able to live near the city, near their work and near their friends?

How painful does "managing expectations" have to be?

the second stop on ross and agnes novie's sunday house hunting tour: Barrington Avenue.

"A Fisbo!" Ross cries. Another sign has come into view: For Sale By Owner.

The possibilities intrigue. Maybe Ross and Agnes will be able to endear themselves to the owner. Impress him with their charm. Remind him of himself, when he was just starting out in the world. Maybe, just maybe, they'll be able to snag a deal.

The house is another cookie-cutter stucco box. Barrington is a busy street, but it's not as if there are mini-malls on the block, or freeway onramps dumping into the house's front lawn (something Ross and Agnes have seen plenty of in the six months they've been looking). The place could work.

If it didn't cost $575,000.

Ross and Agnes find the owner, a middle-aged guy, sitting at a kitchen table with his newspaper.

What the hell, Ross figures. "I'll give you $450,000 for it," he half-jokes.

The owner's lips curl into a barely perceptible smirk. He doesn't even bother to look up from his reading.

Historically, the residential real estate market has moved in cycles—periods lasting about seven years, during which buying activity and prices rise as incomes increase, fall as the economy softens, then rise again when things pick up, usually surpassing old records. What's been going on in the past year or two in Southern California fits the mold, at least in part: The boom represents an expected rebound from the severe housing recession of the late 1980s and early '90s. Between 1988 and 1995, annual unit sales of detached, existing single-family homes fell by 112,279—almost 25%.

Prices fell, too. In Los Angeles County, the median price peaked at $229,260 in May of 1991, then failed to reach that level again for a full 10 years. At its lowest, in December 1996, it dropped to $163,370.

But the current real estate cycle is also an unusual one, because it has kicked into high gear during a period of general economic malaise. The country is only slowly pulling itself out of its recession, and unemployment, which in September hit 6.4% in California and 6.1% nationwide, does not appear to be declining rapidly. Usually conditions like these create falling or stagnant prices, not skyrocketing ones.

"This is not a normal cycle," says Nicolas P. Retsinas, director of the Joint Center for Housing Studies at Harvard University. Michael Williamson, a 24-year veteran of the real estate business who manages the John Aaroe division of the Prudential California Realty office in Studio City, agrees. "We've been saying, 'This can't last' for a year or more," he says. "But the people who last year decided to wait are now paying 20% to 25% more for their homes. This may not slow down. It's an odd cycle."

The curious timing and the outrageous scale of the boom have led many to wonder if what we're seeing is a "bubble"—an irrational escalation of prices, fueled by speculative frenzy—that's doomed to burst when people's brains catch up with their pocketbooks. Indeed, psychology is a major force in today's market. When things are hot, sellers expect to have multiple bidders, and buyers expect to overbid, which keeps prices on the rise. People become afraid of getting "shut out of the market" and are willing to pay more than what's rational.

But it's probably a mistake to expect the current housing market to behave like the stock market of the late 1990s. "There is no bubble!" says Raphael Bostic, professor at USC's School of Policy, Planning and Development.

Bostic's reasoning—shared by Harvard's Retsinas and senior economist Christopher Thornberg of the UCLA Anderson Forecast—is that there are rational explanations for the price increases, outsized though they may be. "It's Economics 101," Bostic says. "A simple formula: Supply and demand."

As he sees it, three factors have pushed home prices here through the stratosphere. First, the Los Angeles area has weathered the recession relatively well compared to other parts of the country. This has kept demand healthy. Second, mortgage rates—currently hovering around 6%—have been holding at 30-year lows, which has made it cheap for buyers to borrow money. "Even though the nominal price of a house has gone up, what people pay for their monthly mortgages has stayed steady," Bostic explains. There's a sense that if you want to get into the housing market, you've got to do it now, while the mortgages are cheap. Again, a boost for demand.

The third reason for the boom? The other side of the equation: Housing supply in this region is incredibly low. Local zoning regulations prohibit new and higher-density building. What's more, homebuilders, many of whom got burned by overbuilding in the 1980s, today limit potential losses by tightly controlling the number of homes they put up. The result, Bostic thinks, is that California is annually producing 50,000 housing units too few to accommodate the number of people moving in. Thornberg agrees. He says that in the late '80s, builders put up one new housing unit for every two-person increase in the population. During the past couple of years, the ratio has been one for every six.

Also, many existing homeowners, spooked by the market's high prices, are choosing to remodel rather than sell. So the picture becomes clear: There just aren't enough houses out there.

It's this last factor—the sharply constrained supply—that has made the process of house hunting in Southern California so completely nuts. Sure, it's tough finding a house that fits your price range. But it's pure torture, once you've found that house, to then have to fend off 20 other bidders who want it just as badly as you do. The psychology thing kicks in. Competition often pushes prices tens of thousands of dollars above the asking figure. And the process, from listing the property to accepting an offer, happens very quickly—often less than a week after a house goes on the market.

With multiple losing bids for every one that's accepted, it's not surprising that horror stories abound. Every buyer has one. Or two. Or twelve.

Take 36-year old Pamela Rubin, who during a six-month period bid above asking price on two of four houses before finally snaring a townhouse in Santa Monica. (Her winning second bid was $20,000 more than the asking price.) She figures it would have been easier if she had, say, $1 million to spend. But then again, she knows that's no guarantee either.

Or 31-year-old Aaron Bernardin and his wife, Lalima Hoq, 32, who lost out on a place in Culver City's Lindberg Park despite offering $21,000 more than the $499,000 asking price. "I can't believe I'm a practicing physician and I can't buy a normal house," Hoq says. "It's not like we live paycheck to paycheck."

Or newlyweds Allison and Daniel Matas, 23 and 33. One day, they knocked on the door of a condo in Sylmar that had just gone on the market. "The guy opens the door, and he [says], 'Sorry, we have an offer,' " Daniel recounts. "They had 14 offers in two days." Another townhouse in the Matases' neighborhood in San Fernando went on the market at $205,000. Someone made an offer, which was accepted. Shortly after, the new owner put it up for $260,000. "What's ridiculous is, people pay these prices."

new owner put it up for [illegible]. "What's ridiculous is, people pay these prices."

Or Hildy Baker, who has made 12 bids in six months. "I could wallpaper a room with all the offers I've made. And these were not dream offers. These were 'Let's settle' offers." Baker, 52, isn't a first-time buyer. She used to own a house in Van Nuys, which she sold last year at a profit of nearly $100,000. "I've probably walked through 30 houses. Forty houses. Maybe 50," she says. "There is nothing out there. What's out there are pieces of trash. I didn't think I could spend more than $250,000. That was a fantasy. I went to $280,000. A fantasy. I'm now at $300,000. And what you get for that is a tiny house. A house on a busy street. A house on the edge of a busy area. A fixer-upper. No air conditioning. And aside from that, there's a bidding war on every single house. And I lose every time."

In the few weeks that they've been bidding, Ross and Agnes Novie have suffered their share of disappointments, too. The first place they bid on, a two-bedroom house in West Los Angeles, just up the street from the place they've been renting for seven years, was listed at $429,000—but sold for more than $460,000. "Even though we bid $20,000 over the asking price, we weren't even close," Ross says. "We didn't even get a counteroffer."

Then the couple put in a $380,000 bid on a house in Culver City, only to find out after the fact that the house wasn't even available (it was already in escrow). Their third offer, $431,000 for another Culver City property, came in $20,000 lower than the winning bid.

Back on the prowl that Sunday, after walking in and out of several more out-of-range West L.A. houses—some dumps, some with potential, none what you'd call a true find—Ross and Agnes find themselves back in Culver City. "This is where we belong," Ross says. "Yes!" Agnes chimes. They've heard the school system is good, and the place feels like a neighborhood to them.

They pull up to a house that's listed for $469,000. The price seems too low. The home has a happy flowerbed in front, a generous patio out back, three bedrooms, nice wood floors. It also has a slightly strange, but roomy, split-level paneled kitchen and family room addition. This gives it a hint of retro cred. The place is swarming with thirtysomething hipster types.

There must be a catch, Ross thinks. He's seen this before. There must already be offers. "This sounds like a phony show," he tells Agnes. Indeed, they overhear the agent say that the house has been on the market for a few days already, and that there is a bid in. The owners are "still taking offers" through Monday, though. Would the Novies like to put their name on the sign-in sheet?

Cue the shtick.

"It'll go for $500,000," Ross says as he walks away.

"$525,000!" Agnes says.

They walk out to their car. Another anxious-looking couple, climbing into a Volvo, eyes them warily. Ross says: "There's a bunch of little wolves at every house you see."

No one thinks the current frenzy can sustain itself. As mortgage rates increase—and they did creep up from 5.21% to 6.44% between June and September, though they've fallen back to 6.05% since—the number of buyers flooding into the market should begin to shrink.

"We know that if mortgage rates go up, property prices will fall," says UCLA's Thornberg. Some homeowners will see the value of their property decline. But if they've taken advantage of the low fixed mortgage rates, and they're able to stay in their house for a few years, they'll still come out ahead. "That house that I bought for $300,000 is now going to be worth, say, $250,000," Thornberg says. "But the mortgage payment is going to be equivalent for me, because I'm locked in at a nice low interest rate now. I'm OK, as long as I don't have to sell."

The problem is, none of this means things will ease up for people trying to break into the market over the short and medium term. "As soon as the rates go up, everyone's going to be locked down," Thornberg explains. "They're not going to be able to move, because they won't be able to take that capital hit. And that's going to slow up the liquidity of the housing market substantially."

In other words, if more homeowners hunker down and wait for the market to surge anew—and they will, because no one wants to believe his house is losing value—supply will remain low. So, while there won't be 10 people bidding on every termite-infested shack that comes on the market, there probably will still be three—enough to keep the competition cooking. On top of that, any price declines will be offset by higher mortgage rates. Borrowing money will be more expensive. Monthly payments will become more of a burden. "It'll still be hard for buyers," says USC's Bostic. "Just differently hard."

Looking farther into the future, you have to wonder what it all means in the big scheme. Will fewer people be able to own? Perhaps. In general, people are operating with less cushion these days. Zero- and low-money-down mortgages have been great for helping families get into houses, but they leave those families equity-starved and vulnerable when things go bad and they can no longer make their payments.

Harvard's Retsinas likes to point out that over the long term, house prices have "pretty much tracked income." But here's the zinger: He's talking about household income, not individual income. Today, more than 80% of married households have two wages coming in. But as recently as 1978, half of American households had one wage earner. In other words, twice as many people are working to produce the same buying power. In the past, Retsinas says, "If a homeowner had a problem with a payment, not to be politically incorrect, but they'd say, 'Well, I guess my spouse should get a job.' But today, everyone is working. There's no [wiggle] room. So, yes, we are in a very vulnerable time."

Then there's the question of the physical housing landscape itself. With single-family houses so expensive, condos and townhouses are surging in popularity and value, and becoming a legitimate alternative to houses. "It used to be that starter homes were [actual houses]," says Jim Ezell, a real estate agent at Mickie Ardi and Associates in Granada Hills. "Now, condos and townhomes are the starter homes."

But does L.A. have the will to go high-density? And for how long can outlying places such as Riverside and Valencia remain an escape valve for Angelenos? These communities are also seeing prices skyrocket 25% to 30% a year. Could they too become inaccessible to all but the upper middle class and the wealthy?

John Husing, a Redlands-based economist, thinks so. He points to well-intentioned restrictions on construction, aimed at protecting water supply, wildlife and neighborhoods, that are keeping housing supplies perilously low. "The Legislature has effectively put in place limitations that virtually guarantee that California's future middle class, most of whom will be Hispanic, African American or Asian, will be forced to remain renters."

The day is dragging to a close in Culver City by the time the Novies see the house. Just blocks from the city's downtown, it's a two-bedroom cottage, vaguely Spanish in style, with a teeny front lawn, a flimsy awning pasted on its front, a weird dark kitchen with crumbling tile work, too few closets, one pathetic-looking bathroom ("decorative tile," the brochure promises), and a subterranean hutch underneath the master bedroom ("full basement"). To its credit, the house also has a red tile roof, nice decorative brickwork, wood floors, a big backyard and a sunny living room complete with an arched ceiling and a carved wood mantel and fireplace. It has been on the market for three days. The owners want $449,000.

Ross stands, looks around, doesn't say much at first. He rubs his beard. "I like the options it gives us."

Agnes isn't so sure.

"Let's offer $439,000," he says, and starts trying to persuade her. They spend 20 minutes or so walking around the house, leaning in toward each other, inspecting the corners and the foundation and the floors. Agnes remains unconvinced. Eventually, they climb back into the car.

"If we bid $439,000, we won't get it," Agnes says. "It'll go for $460,000."

"So we won't get it then."

"It's so hard to keep things in perspective. It's hard to tell what you're getting and what you're giving up." Agnes takes a deep breath and looks around at the downtown area, at the cafes and the shops.

"All right," she says, after mulling the issue for a minute or two. "Let's get it."

"We won't get it though," Ross reminds her.

There is a silver lining here. few experts seem to think the current swell in the market is forever going to lock middle-class people out of owning real estate. Indeed, most middle-class people who really want to buy a house eventually do. Even today. They figure out what they can afford in terms of location, size, condition and price. They are diligent about getting bids in quickly. And eventually their offer is the one that wins the race. "If people are serious, they adjust," says David Wood, a Prudential agent in Studio City.

The buyers are generally thrilled when it finally works out for them. Aaron Bernardin and Lalima Hoq are negotiating a Fisbo sale. Pamela Rubin found her townhouse. Allison and Daniel Matas snagged a two-bedroom $265,000 house in San Fernando and say they're looking forward to enjoying sunsets on their new porch. Even Hildy Baker's persistence paid off. She landed a three-bedroom place in Canoga Park. At $350,000-plus, it's more than what she wanted to spend and it's a little farther north than she wanted to live, but she's happy.

"The house is precious!" she said while still in escrow. "But if anything happens with this one, I'm done. That's it. I've said it before, but this time I really mean it. I'll take the money and I'll get my eyes done."

Ross Novie phones, breathless, on a Monday night in September.

"We just got a call," he says. "We got the house."

He and Agnes had taken a walk through the neighborhood with their dog that morning, and had decided officially that they liked it. While "some of the streets are downscale," there were a lot of cute houses—houses that looked as if people cared about them. The couple decided they could see themselves there.

They bid low at $435,000 and—who would have thought, in this overheated market—the sellers accepted. They were eager to seal their own deal on a house in Glendale and get their kids registered for school. It was really almost a fluke.

Agnes is watching TV, so she hasn't processed it yet. "She's waiting till the movie's over to freak out," Ross says.

So what happens now?

"I don't know," he laughs. "I start writing checks for my ridiculously overpriced house?"

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