REAL ESTATE MARKET SOURCE

OF SOUTH CENTRAL WISCONSIN

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THIRD QUARTER, 2006


Dave Stark

We are currently witnessing a phenomenon that I have not seen in my nearly 30 years in real estate brokerage. For the first time in anyone's memory, we are seeing a noticeable slowdown in sales despite continuing record low interest rates. I've experienced many soft markets before; most (1980 – 1982 particularly) were far more severe than this. But all of those were precipitated by rapidly rising interest rates. This one seems to be occurring even though rates have actually fallen (that's right, fallen) over the past 60 to 90 days by nearly two thirds of a percentage point, remaining near all time lows. At this writing, 30 year rates are around 6.375%. What's going on?

I've heard many explanations offered, and many have some validity. For starters, the Federal Reserve has raised short term interest rates steadily over the last two years. This has probably led many consumers to assume that mortgage rates were rising too. They did rise a little, but not much… they're still within a percentage point or so of their lows. It's also true, as you see below and on the following pages, that inventories have continued to rise, leading many to assume that the market is "slow," since they see more for sale signs than they're used to. Perhaps most importantly, the media has been relentlessly predicting a "bursting real estate bubble" for two years now, and they've seized on any evidence of a slowdown to fuel the gloomy predictions. While fears of a bursting bubble are utterly unfounded, especially here (see page 2), we're hearing that many buyers are afraid to buy, thinking that real estate has become a bad investment on which they'll lose money. A self-fulfilling prophecy if ever there was one. Add in the fact that the fall is normally the slowest time of year anyway, and the market appears just plain tired after a sizzling 5 year run.

We'll do our best to help you make sense of this market in this issue. For now, there's no hiding the fact that sales for the 3rd quarter were down 18% for the full area covered by the South Central Wisconsin MLS, and down 24% in Dane County. **However, year to date sales for the entire market are still 2.5% ahead of 2004, which was then a record year.** Prices have stayed firm in almost all markets. But inventories have doubled in many areas over the same two year time frame, so sellers face a challenge for the next few months, while buyers have an unprecedented opportunity. No one knows how long this will last, but with rates this low, things could pick up again very quickly.

We hope you enjoy this newsletter, and we welcome your feedback to help us make it even better! Feel free to email us at
Feedback@StarkHomes.com

FULL MLS

	Single Family			Condominiums			Total Residential		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
3rd Quarter Sales*	3,340	4,027	3,590	732	965	795	4,072	4,992	4,385
YTD	9,566	10,504	9,550	2,111	2,214	1,836	11,677	12,718	11,386
Average Price	$203,527	$200,727	$194,482	$179,122	$182,257	$175,399	$199,142	$197,145	$191,029
Active Inventory	8,280	6,178	5,008	3,180	1,944	1,177	11,460	8,122	6,185
Inventory Days	277	171	156	485	225	165	314	181	157

DANE COUNTY

	Single Family			Condominiums			Total Residential		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
3rd Quarter Sales*	1,397	1,807	1,760	566	766	652	1,963	2,573	2,412
YTD	4,130	4,772	4,614	1,598	1,770	1,496	5,728	6,542	6,110
Average Price	$274,366	$266,821	$251,011	$182,159	$178,374	$180,604	$247,806	$240,401	$232,005
Active Inventory	3,118	2,238	1,588	2,407	1,398	695	5,525	3,636	2,283
Inventory Days	249	138	101	474	204	119	314	158	106

* Closed sales reported to the SCW MLS between 07-01-06 and 09-30-06. "Inventory Days" represents the number of days it would take to sell the entire active inventory at the pace of sales for the most recent quarter represented, adjusted to account for seasonal variations.

WHY WE NEED NOT FEAR THE BUBBLE

Talk about the "bursting real estate bubble" is so pervasive these days, it's no wonder many buyers think it's true. It's not, and there are good reasons why it's not. While it may sound like semantics, a bursting bubble is a very different thing from a normal market correction, and understanding the difference will help you make sense of what's happening today.

Today's bubble talk is rooted in the experience many of us had in 2000, when the dot-com bubble burst. The lesson many people (and newspaper reporters) learned was, if prices go up too fast, they'll come down just as fast. Since real estate began appreciating faster after 2000, many started predicting that we were experiencing our own bubble, and they are now trying to convince us that our day of reckoning has come.

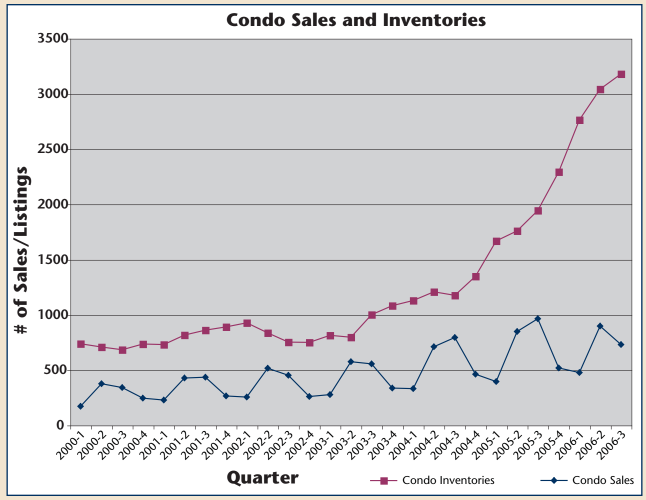
It hasn't, because we're not in a bubble, especially in south central Wisconsin. The dot-com bubble was a true bubble. Why? As Kendra Todd, host of HGTV's "My House is Worth What?" and a regular contributor to Fox News Live reports in an excellent piece published on Yahoo Real Estate on September 26, 2006, "A bubble is a market in which the value of the key asset is inflated based on speculation and psychology… That's why the Internet boom of the 1990'a was a true bubble; people suddenly realized that ninety percent of the dotcoms were companies with no way to make money."

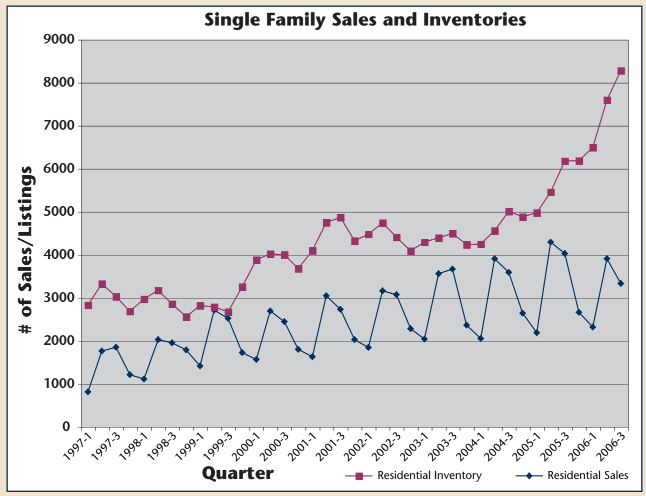
When companies are being valued in the billions with no way to make money, that's a bubble, and it had to burst. Real estate does not work that way. Real estate has intrinsic value. A stock certificate is worthless except as an investment vehicle. A house has utility. You live in it. A home's value first and foremost is defined by what it costs to build it. Because everyone needs housing, the demand for housing as an asset class is continuous, and grows as the population grows. It can be higher in some areas of the country than others (and has been) but on the whole, housing experts tell us that we need to build more housing units over the next decade to keep up with demand. So there's fundamental value in real estate as opposed to stock certificates, which can become worthless overnight.

So what's a market correction? In the short run, the balance of supply and demand pushes prices of any asset higher or lower. Prices in a dynamic free market never settle exactly on "true value." Sometimes they're a little high, sometimes a little low, but over time, they usually remain in touch with the fundamentals. What we're seeing now is the balance of supply and demand tipping in favor of the buyer. That will slow the increase in prices, and some homes will undoubtedly sell for less today than they might have a year ago. But that's a far different thing from a bursting bubble. **If you're looking to buy a home in 2006 and flip it immediately for a profit, you might well lose money. But if you're buying a home in our market to live in for years, you've got little to worry about.**

There are markets around the country that have seen a speculative run up in prices, and those markets may well experience something more akin to a bursting bubble. In markets like Las Vegas, Reno, or Florida, people were buying new homes and selling them immediately for a profit, sometimes two or three times, before someone finally moved in. That's speculation, breaking the link between true value and market prices, and those markets are now suffering far more than we are here. In our market, high inventories are the main driver behind this change in the balance. As you can see in the accompanying charts, inventories have skyrocketed over the past year. Until inventories are reduced, prices will be flat. But with rates this low, demand for good properties will remain strong, and that, coupled with construction costs, will create a baseline for prices.

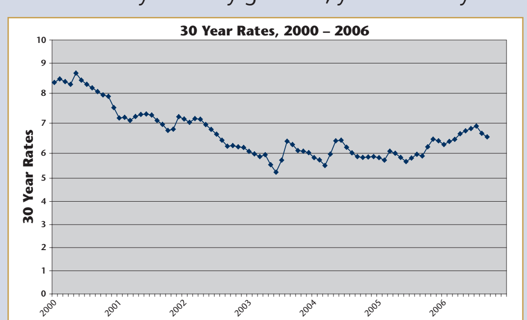
So, don't fear the bubble. It doesn't exist here. If you need or want to buy real estate, and you're in it for the long run, buy it. As long as you live in it, it will reward you with high returns, not all of them financial. But if you sit it out and miss this opportunity, well…don't say you weren't warned!





SO YOU THINK RATES ARE HIGH?

Check out the accompanying chart, showing 30 year rates month by month since January of 2000. For even more historical perspective, see the interest rate chart we published in our first quarter issue, which you can find on our web site, www.StarkHomes.com. As you can see, mortgage rates have barely moved since the Fed started tightening. This is another reason we'd be surprised if demand stays low for long. We don't know, of course, if they'll stay this low forever, but with energy prices falling and inflation more or less in check, there are very few influences pushing them up. If you commit today and they go lower, you can always re-finance.



NEWS
"Housing Taking Bigger Bite. Costs relative to income rising across the US." (*Wisconsin State Journal,* October 3, 2006, by Stephen Ohlemacher from Associated Press)

VIEWS
Once again, the local media has picked up a national story with limited applicability to our local market. There was a statement included in the article that *"In Wisconsin, the average percentage of income spent on housing costs rose to 21.6 in 2005 from 18.3 in 1999."* The article then goes on to state that, *"Monthly costs for people in state* **carrying a mortgage** *rose to $1,258 from $1,161 in 2000…"*

The article is based on recently released data from the US Census Bureau's "American Housing Survey." I found the survey on the Census Bureau's web site, and I found the data for Wisconsin mortgage costs mentioned above. **However, on the same page is some data not mentioned in the article: between 2000 and 2005, average family income in Wisconsin increased 10.84%, while the mortgage cost mentioned above increased 8.35%.** In other words, for Wisconsin, average family income increased faster than mortgage costs, contrary to the entire thrust of the article. The increase in housing costs relative to income highlighted in the article was for all types of housing, including rental costs.

CONCLUSION
It is true that for some of the period from 2000 to 2005, rental costs in Wisconsin were increasing faster than incomes. However, during the same time, ownership costs were actually falling, and the result has been that many renters have chosen to become owners. Furthermore, the resulting net reduction in the number of renters has created a glut of rental units in our market, so we're now seeing effective rents falling back a little bit too. It is undoubtedly true that ownership costs are much higher in many states, particularly those on the east and west coasts, where most national journalists live. **But here in Wisconsin, our housing costs remain right in line with incomes. Affordability is not a problem in Wisconsin.**

NEWS
"Growth in Home Prices Show Sharp Slowdown in 2Q" (*USATODAY.com,* September 5, 2006.)

VIEWS
This article was based on the release of 2nd quarter price data from the Office of Federal Housing Enterprise Oversight, or OFHEO, to which I subscribe. It is by far the most reliable gauge of home price changes, since it tracks repeat sales of individual properties across the nation to calculate *actual*, as opposed to average, price increases in metropolitan areas. OHFEO reported that prices increased 1.17% nationally for the second quarter of '06, or an annualized rate of 4.68%. However prices were actually 10.06% higher than they were one year earlier. In other words, prices increased 8.89% from 7/01/05 to 3/31/06, but only 1.17% thereafter.

The OFHEO report contains data for the Madison MSA, which ranked 185th out of 275 MSA's measured in total appreciation over the 12 months ended June 30, 2006. Our appreciation for the past year was 5.17%, about half the national average. Our appreciation for the quarter was 1.58%, slightly above the national average. For the past 5 years our prices have increased 39.55%, or an average of 7.91% per year. The national average is 56.49%, or 11.3% per year. (Wisconsin as a whole ranked 41st for the past 12 months at 5.58%, very close to Madison.)

CONCLUSION
Home price increases have slowed in 2006, and our guess is that OFHEO's third quarter report, not due out until after we publish this issue, will show a little further softening. However, as OFHEO says in their report, "Prices in states that experienced relatively limited 2001 – 2005 appreciation have generally seen only modest decelerations." That is certainly true of Wisconsin, and of Madison.

STRATEGIES FOR SELLERS AND BUYERS

SELLERS
For at least the next couple months, we probably have a full fledged buyer's market on our hands. If interest rates stay low, which we think they will, activity might well pick up next spring. But we've said it before and we'll say it again: this is not the time to try a high price. Buyers have too much to pick from, and they're buying the best deals. We've seen many examples of sellers who've gotten less than they would have had they priced their home properly to begin with, and they had to wait longer to get it. Once you become shopworn, there's no telling how long it will take, and it may well cost you more to hold the property than it would simply offering a realistic price up front. Don't be stubborn. We're still finding that well priced and presented properties are selling very quickly, sometimes even with overbids, so offer the most attractive package you can, get the best market advice you can and this market can still reward you. Buyers can afford to buy at today's rates, and the smart ones are, so it's not all doom and gloom. You simply need to be competitive.

BUYERS
Buyers right now are being presented with a virtually unprecedented window of opportunity. We can't remember ever having seen the combination of low interest rates and high inventories we have today. Since we can't remember seeing it before, we can't really predict how long it will last either. However, many in our industry think that activity will pick up smartly next spring (at this writing, there's some evidence that it already is), so procrastination is likely to cost you. For reasons expressed elsewhere in this newsletter, we don't see overall prices dropping, but you might have some negotiating leverage with some sellers in the short run. If you have another property to sell, see the advice (at left) for sellers. If you buy right, you can afford to sell right. If you wait until it's easier to sell for more, you'll likely pay more too. Lock in today's prices now, especially if you're moving up; they won't last forever. You'll earn higher appreciation over the long run on a higher asset base.

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TREND WATCH

Likely direction next 6 months

Number of homes sold (annualized)* — Direction: ↓

	Full MLS	Dane Co.
3rd Quarter, 2006	14,846	7,153
2nd Quarter, 2006	15,593	7,628
3rd Quarter, 2005	15,816	8,072

* Sales for 12 months ended 09/30/06

Comments: 2006 will finish soft, but next spring could quickly improve.

30 Year Mortgage Rates — Direction: ↔

September, 2006	6.53
June, 2006	6.81
September, 2005	5.90

Comments: Rates have eased a little bit, and will move in a narrow range for a while.

Average Residential Price – Single-Family & Condos — Direction: ↔

	Full MLS	Dane Co.
September, 2006	199,142	247,806
June, 2006	198,571	243,828
September , 2005	192,040	235,185

Comments: Our earlier prediction of 4% appreciation for the year is looking pretty good.

Building Permits – Dane County Single-Family — Direction: ↓

	3rd Quarter	YTD
2006	295	1,116
2005	591	1,827

Comments: Permits will stay low until inventories start to fall. Specs will be minimal.

Inventories – Residential & Condos — Direction: ↔

	Full MLS	Dane Co.
3rd Quarter, 2006	11,460	5,525
2nd Quarter, 2006	10,637	5,152
3rd Quarter, 2005	8,122	3,636

Comments: It looks like they'll stay high until the end of the year, but we still think they'll fall next spring.

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