| SiRuDo Realty, LLC<br>3025 Bull Street<br>Suite 229<br>Savannah, GA 31405<br>912-232 8686<br>www.sirudorealty.com | | Quarterly Newsletter<br>September 2013 |
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## **Welcome**

Dear clients,

I hope you all enjoyed another wonderful summer and are ready for the fall.
I have tried to capture the market activity over the past few months in three articles that I believe will be of interest:

- The New American Dream: Rent
- What happened to mortgage rates?
- Bullish on Savannah rental market

As all of you know, the property management and rental market is not an insulated market segment and is sensitive to what happens in the broader financial and economic climate that surrounds us.
I hope this newsletter adds some clarity to the broader spectrum and contributes to a more encompassing view and approach.

Feel free to contact us at tdoms@sirudorealty.com or ndoms@sirudorealty.com if you have any questions or comments regarding the topics in this newsletter.

Best regards and happy reading.
Nick Doms

# The new American Dream: Rent

At the start of the financial crisis and the collapse of the housing bubble, I had a very interesting conversation with a few colleagues about the future of homeownership in the US.

The premise of my explanation back then was that the American dream of owning a home was exactly what the word said: a dream.

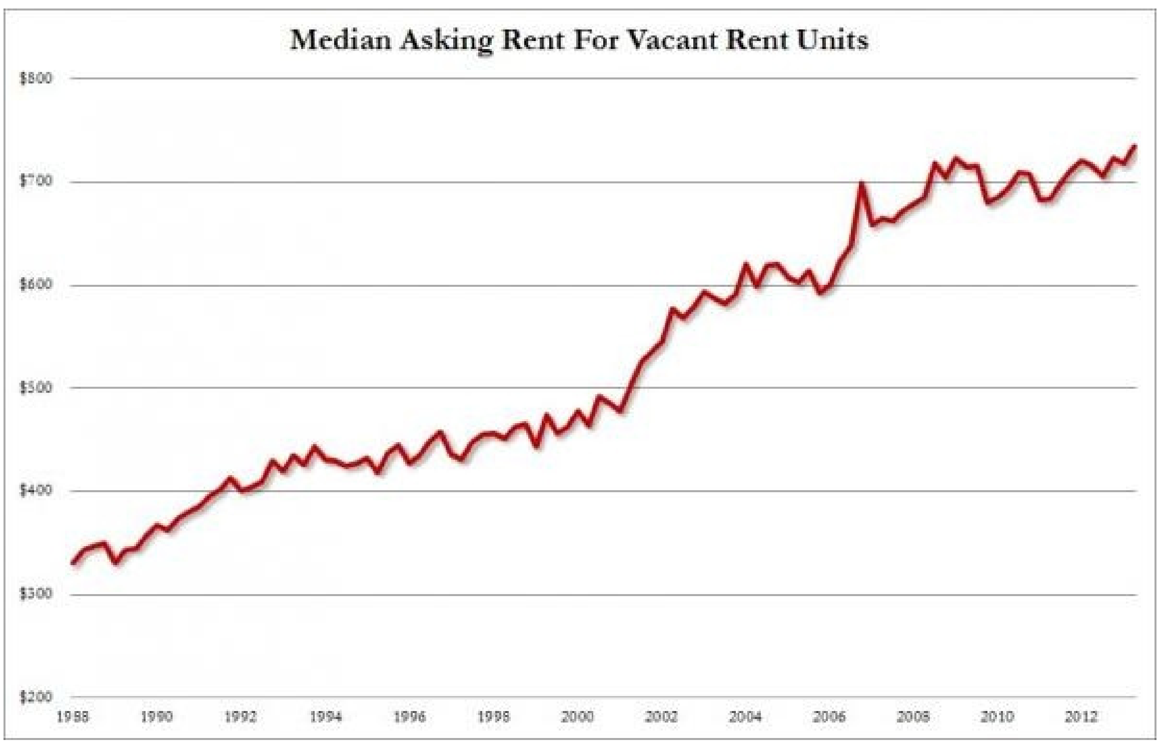
Needless to say that my explanation and rationale were considered controversial and contrary, which is nothing new.

But now we are five years later and the landscape has changed towards a new American dream: renting instead of owning.

The immediate reaction to explain this phenomenon is to point out that spendable income has declined due to high unemployment, part-time jobs and economic insecurity that negatively impacts the desire to purchase a new home with all the long-term financial liabilities attached to it.

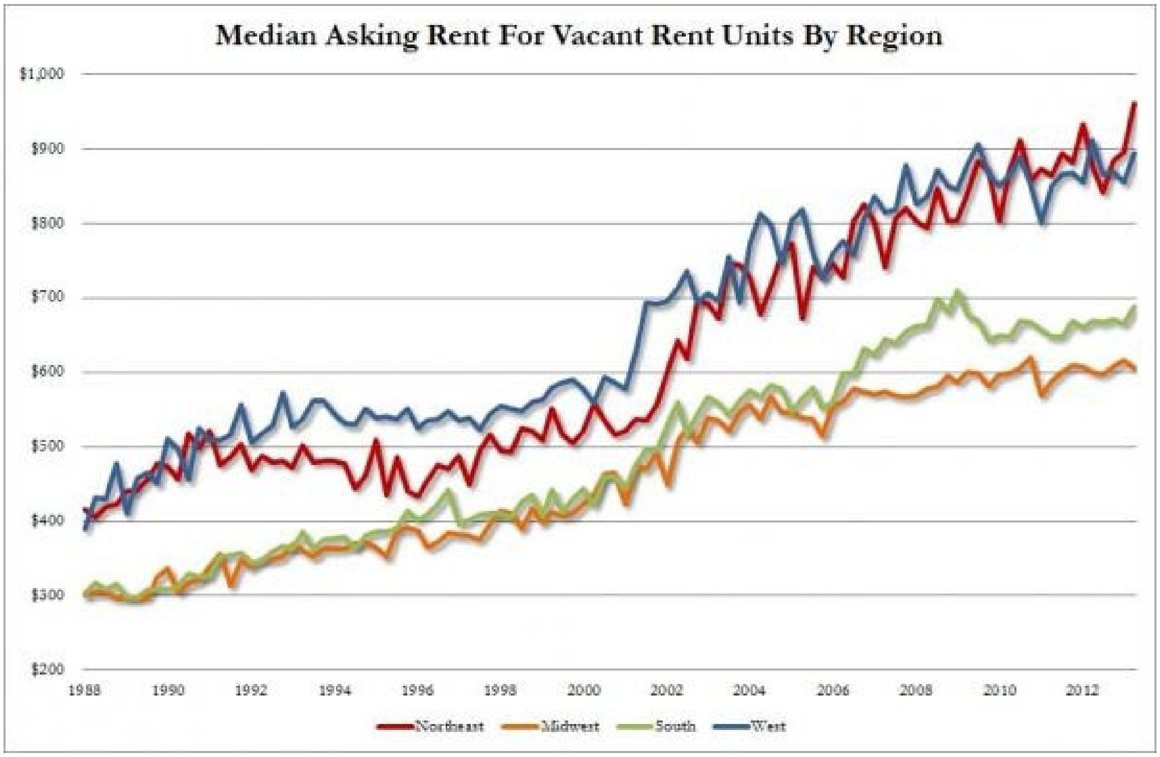
To a certain extent this is a factor but there are other parameters at work that tilt the landscape from owning towards renting and the trend will continue in that direction for the foreseeable future.

That is of course my controversial and contrarian view, but let's take a look at some interesting statistics to substantiate my reasoning.



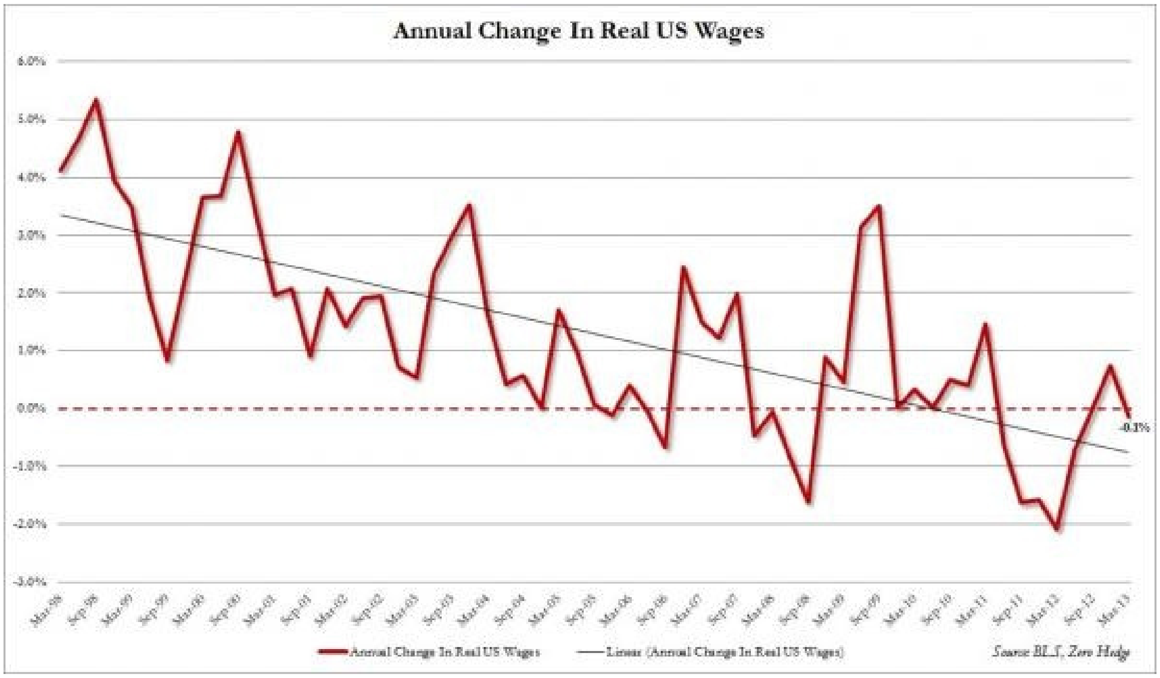
Notice how remarkably stable and steady the median asking rent is during the 2007-2012 period when the housing market collapsed. I will address this curious phenomenon later.

Now let’s look at the median asking rent per region so we can exclude any national trends.




Other than the Midwest region, all regions show a stable growth in asking rent despite the sharp economic downturn.

The last graph that is interesting to look at is how spendable income has changed during the same period and specifically between 2008 and 2012.
One would expect that such graph would be similar to the ones above in order to explain the switch from owning to renting.
At least that would be a very easy and acceptable explanation, but we know that is not what occurred.




Now we know that spendable income cannot have an impact on the change of course, otherwise we would see a decline in asking rent due to high vacancy rates, neither one of which has occurred since 2008.

That begs the question; what makes people more prone to rent than buy and why is this happening now?

The most important answer can be found in how Federal financial intervention has impacted State spending and how Federal budget decisions have alienated State budgets that trickle down to the regional and local consumer.

For example; States have been given Federal funding to offset the cost of public schools, public transportation, homestead exemptions and State or County services which have kept State, County and City taxes at the same level, more or less.

Once the financial crisis hit and the Federal Government is forced to find ways to balance (more or less through creative accounting) the budget, State programs become the first target.

That means States can no longer rely on full Federal funding for all their public programs and in turn are forced to raise taxes, cut their programs or implement a combination of both.

Now let’s return to our housing conundrum and let’s get our usable facts in a row:

-Spendable income declines or stagnates

-Asking rent goes up

-Mortgage rates go down or stay stable

-Property taxes go up

Without doing the math, we can already see that the decision parameters and variables are contradictory. We just have to find out which one weighs heavier on the budget equation and for how long.

Spendable income and rents will start or continue to go up since both parameters fluctuate with the prevailing inflation rate. That means both are negligible for our purposes.

That leaves us with mortgage rates and taxes.

Mortgage rates are bound to go up to pre-crisis level and will reach a normal level of 7% for a 30-year fixed conventional loan (see the following article).

That in itself will not be a dominant variable in the decision to buy or rent, but County and City taxes will become the main culprit and it already has.

It is a given that local property taxes are going to weigh heavily on the buyer's spendable income to such an extent that it will become a deal breaker.

The simple calculation that real estate agents and brokers used ten years ago, i.e. if you spend $800.00 on monthly rent then you can afford a mortgage for less is no longer a valid argument.

Add another $200.00 for taxes and $100.00 for property insurance and if the monthly $1,100.00 is within the buyer's budget, then he/she can afford a small home.

Add monthly reserves for repairs, replacements and maintenance and the monthly rent budget fades in comparison.

I started off this article by warning all that my views are contrarian and controversial in nature but if you follow the new road of taxation and the shift from Federal to State with a trickle down effect on County and City then you will find that my model is closer to reality than we would wish.

Now, if we were to implement the European model of homeownership then I am ready to rewrite the future of the American Dream, but that is something for another newsletter.

Until then, watch the rental market flourish as long as Property Managers and Landlords follow suit.

Do not worry! SiRuDo Realty is like State Farm: "You're in good hands."

## What happened to mortgage rates?

That has been the most frequently asked question by first time homebuyers in the past 3 months.
The second logical question is of course whether or not mortgage rates will come down again to previous levels.
I hate to disappoint, but the answer to the first question is because of the main force behind mortgage rates, namely the Federal Reserve and its Quantitative Easing, and the second answer is a resounding NO!
Let's go back to 2008 when mortgage rates first started falling to historical levels.
When the Federal Reserve launched its Quantitative Easing round I, they purchased large amounts of 10-year US notes and 30-year US bonds in the open market, thereby raising the price and lowering the yield.
Round I was followed by 2 more rounds of massive purchases for a total of $3.2 trillion, the assets of which were kept in three SPVs (Special Purpose Vehicles) named Maiden Lane I, II and III.
By early 2009, the Federal Reserve had three large portfolios each consisting of US Bills (Short term), US Notes (mid term) and US Bonds (long term) that allows them to easily swap their holdings internally and change the weighted average duration of the portfolios to keep the yield curve in the market low and stable.
The same yield curve impacts the mortgage rates including ARMs, conventional, FHA or VA long-term loans (15 to 30 year maturity) give or take an additional 75 or 100Bp depending on the bank and the underwriter.
Since there is a direct correlation between the yield curve and the mortgage rate, it is easy to deduct that if the Federal Reserve changes its holdings by making reversed swaps (from long-term to short-term) or by outright selling part of their holdings that the mortgage rate follows suit immediately.
That brings us to mid-May 2013 when we saw a spike in the 30-year mortgage rate from 3.40% to 3.98% in less than 4 weeks. That is an increase of 17%.
What exactly happened that caused such a jump in mortgage rates and why do they stabilize at current levels of 4.375%?
In May 2013, Ben Bernanke hinted at ending the Quantitative Easing of $85 billion/month and at slowly raising the short-term interest rates prior to year-end.
That announcement triggered an avalanche of bond activity primarily from portfolio managers, pension funds and insurance companies that saw large reversed swaps from long-term to short-term paper, which caused the long-term yields to spike up and the mid-term yields to creep higher.
In essence, we saw what is commonly referred to as a "steepening of the yield curve" whereby short-term yields remain stable but long-term yields jump higher.
The mortgage rates followed suit since banks and underwriters use the mid and long-term yields as a base to calculate their mortgage rates.

While it may be that the Federal Reserve has since tried to assure the markets that QE will not end and that interest rates will not be raised given the modest economic growth, traders know that when there is smoke, there is bound to be a fire somewhere.

They are absolutely right! Ben Bernanke and team are not selling their holdings, they are simply positioning their portfolios towards the short-term yield curve and swapping 30-year bonds for 2-year notes or shorter.

That is a pre-emptive move in order to raise interest rates when the economic lights turn to yellow from red.

Going back to my previous resounding NO answer to the question whether or not mortgage rates would trickle back down, now we can see why.

What we see in the mortgage market is here to either stay or go up and my prediction is that by the end of 2015 we will see mortgage rates back to the pre-2008 level of 6.5% or 7% supported by a GDP growth of 3% and an inflation rate of 1.75%.

That sounds an impossible scenario in comparison to the pre-crisis economic models we are used to but this is a brave new world where the once abnormal has become the new norm.

As with every new game, we learn the tricks to gain an advantage and this one is no different. It is called points for basis points and it will make it possible to borrow below prevailing market rates.

## Bullish on Savannah rental market?

According to a recent article in BiS (Business in Savannah) dated 8/21/2013, analysts are bullish on the Savannah rental market despite a supply increase that is either in progress or planned.
Real Data, an apartment market research firm, released its annual report on the Savannah-Hilton Head rental market and expects strong leasing activity.
Around 1,600 new units are under construction or are planned, which will meet the current demand levels, according to the study.
A few statistical data in the report stand out and are worth sharing here:
-The vacancy rate for greater Savannah has dropped from 12% in 2008 to the current 5.2% and is expected to remain at this level for the next two years independent of the new supply in the market.
-The average rental rate has increased from $790.00 in 2008 to $858.00 today. That represents an increase of 8.5% over a five-year period or 1.7% annually, which is in line with the prevailing inflation rate.

Two new rental unit projects are of particular interest to Landlords with property in or close to Midtown Savannah: The Avenues on 61st Street and One West Victory Drive.

The Avenues on 61st Street are being finished and leased at the time of writing. The complex is located on 61st Street between Habersham and Abercorn and is comprised of 32 townhouses (4 bedrooms) each with a 2-car garage. The asking rental price is $2,000.00/month and primarily promoted to SCAD students given the proximity of Montgomery Hall and the Gulfstream building.

The second apartment complex, One West Victory Drive, will feature 114 units of different sizes with parking garage and is expected to attract SCAD students as well. The complex is currently under construction and is expected to be finished mid to late 2014. Rental prices are not yet available but can be expected to be in the same price range as the Avenues on 61st Street.

The new complexes, including the new and improved Drayton Tower downtown, will have a trickle down effect on other rental properties but those should be easily filled by young professionals as long as they are in good condition, in a good location and at par with the newly built units.

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