FORECASTING HOME PRICES

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In 2004 home prices began a sharp rise. By the end of 2005 Local Market Monitor reported that many local markets were severely overpriced.

Prices peaked in early 2007 and by the end of 2012 had fallen as much as 60 percent. After prices hit bottom, a rush of speculation in foreclosed homes ensued in some markets.

These highly unusual circumstances were different from the classic home price cycle of too much local demand followed by too much local supply. National economic factors - low interest rates, government housing policy, sub-prime mortgages - drove these price changes and made local forecasting irrelevant. When everything is going up or down you might as well just go with the flow.

After a decade of this turmoil, real estate markets have now reverted back to normal - that is, local conditions again drive local home prices.

Careful investors, mortgage lenders, developers and home builders now want to know where local conditions will be favorable - and where they'll be poor. A good home price forecast will give a meaningful boost to investment returns.

BETTER FORECAST TOOLS

A big improvement in forecast technology - validated during the boom and bust - is the concept of a calculated comparison price that shows if a local market is over or underpriced and by how much. We call our comparison price the Equilibrium Home Price, or the Income Price.

Our comparison price showed many markets heavily overpriced in 2005 - before the crash - and heavily underpriced in 2012- before the recovery.

HOME PRICE DATA ARE FUZZY

Our goal is to forecast the increase or decrease in the value of the average home in a local market, but there is no way to accurately measure that value. The most reliable estimates are provided by repeat sales of the same home over the years. This is the basis for the home price indexes calculated by the Federal Housing Finance Agency and by Case-Shiller. The statistical nature of these indexes means that some uncertainty is built into the estimates, and the fact that they rely on actual transactions increases the uncertainty because the transactions may not involve typical homes or typical sales.

The uncertainty of the data means that forecasts of home prices must concentrate on meaningful ranges rather than on specific numbers.

OUR FORECAST METHOD

Very simply, our method starts with the most recent change in home prices in a local market and modifies it by the recent trend of change and by expected future economic conditions - changes in jobs and in demand for housing. Our method also takes into account the volatility of a local market, the comparison price described above, and the typical trajectory of prices at different points in the price cycle.

The goal of our forecasts is to identify local markets where home prices will be strong, and those where they will be weak. Strong is an increase of 15 percent or more after two years. Weak is an increase of less than 5 percent after 2 years.

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