What does the Future Hold?

A Not-So-Rosy Outlook -- But There's Hope
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U.S. Economic Outlook
Housing is shifting to the slower lane.
September 2006

Home sales and home price growth forecasts have been lowered measurably. The past couple of months of housing data have been much lower than anticipated. Take a look at some of the recent figures: July existing-home sales were down 11 percent from a year ago July pending home sales were 16 percent lower from a year ago July new home sales were down 22 percent from a year ago June and July single-family housing starts were down 14 percent and 17 percent, respectively June and July single-family permits were down 17 percent and 23 percent, respectively June and July mortgage purchase applications were down 19 percent and 24 percent, respectively Inventories for both new and existing homes were at an all-time high - 4.4 million homes on the market, which is equivalent of one listing for every 17 homes in the country Home prices have been crawling with less than 1 percent appreciation from a year ago in the recent two months That is not all. The economy has also been underperforming. The net payroll head count rose by an average of 142,000 per month in the past 12 months. In an expanding economy, the count should be above 200,000 per month. The forecast for GDP growth for the remainder of the year is also weak at only 2.5 percent. The weakening in the housing sector is the prime reason for the sub-par growth. The only positive news is the recent declines in mortgage rates. From a cyclical high of 6.8 percent at the end of June, 30-year fixed rates have trended lower since then with the latest weekly reading (as of September 8) coming in at 6.5 percent. Had rates continued their upward path and reached 7.5 percent, perhaps a third of the country's housing markets would be experiencing home price declines.

What's Ahead?
Looking down the road, we see stabilizing mortgage rates and a modestly expanding economy through 2007. But housing will shift to the slower lane. The national forecast is for existing-home sales to fall 8 percent in 2006 followed by another 2 percent decline in 2007. The more cyclical new home sales will fall by an even greater amount -- 16 percent in 2006 and 7 percent in 2007. Correspondingly, the residential construction-spending portion of the economy will contract 3.4 percent in 2006 and 8.5 percent in 2007. In other words, $21 billion will be subtracted from GDP in 2006 and another $49 billion slashed in 2007.That would be a sharp contrast to near $50 billion additions during the housing market boom. (There is a caveat: any significant shifts in mortgage rates and the state of the economy will alter the outlook.)

And, Home Values?
Home price growth will be minimal at less than 3 percent in both 2006 and 2007. But it is again worth emphasizing that all real estate is local. Some local markets will post much softer figures than that for the nation as a whole. Home price-to income ratio, home price-to-rent ratio, and more importantly, mortgage debt servicing cost-to-income ratio have greatly increased in some markets to worrisome levels. The ratio metrics in Florida, California, Arizona, Nevada, Virginia, and Maryland markets exhibit trends far above local historical norms. So it would not be surprising to see price declines in these states. These states do have solid job growth, however. So any price declines can be neutralized somewhat as new job holders provide demand support for the housing market. If,

however, mortgage rates were to rise measurably -- to say 7.5 percent or 8 percent from the current 6.5 percent -- for whatever reasons (be it Chinese dumping dollars on the market, higher inflationary expectations, or more monetary tightening by the Federal Reserve), then these markets will undoubtedly come under intense pressure.

'An Inevitable Downturn'

Economist and real-estate researcher Karl Case explains what the market slowdown could mean for homeowners—and for the economy.

By Daniel McGinn
Newsweek

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Sept. 28, 2006 - For people who've spent the last five years holding forth about the unsustainable housing bubble, this week brought long-awaited news. While home sales have been slowing for months, prices had been holding steady—until now. On Monday the National Association of Realtors reported the median U.S. home price dropped 1.7 percent in August from a year earlier, the first annual decline in more than a decade. NEWSWEEK's Daniel McGinn spoke with Karl Case, a Wellesley College economist who has been studying real-estate trends for more than two decades, about how housing busts typically play out—and how this one seems different from the past. Excerpts:

NEWSWEEK: So prices have finally begun to fall. Is that surprising?
Karl Case: It's been an incredible run. If you go back 30 years, we've had two prolonged, steadily increasing price periods—from 1983 to 1988, then from 1994 until now. Prices have gone up enormously. The fact that the market is finally encountering some resistance is hardly surprising.

A lot of people don't remember the home-price bust of the late 1980s and early 1990s. How long did they last, and what's different this time?
The thing that all these periods have in common is the first thing that declines is demand. I wrote recently that it's like somebody blows a whistle that only dogs and buyers hear. That happened in 1987 or 1988, and it's happened now this year. The market reacts in fairly predictable ways. When demand drops, sellers are either in denial or they strategically decide to wait it out. They won't lower their price right away. You can certainly understand that when you see large numbers of FOR SALE signs up. If we auctioned all those houses every day, we'd see much more volatility. But people set a price and they sit on it for a while. So when demand declines, it's not the price decline you see first—it's the quantity declines. You see existing sales fall off. You see housing starts fall off. That's what we're seeing now for sure.

Then whether that results in an ultimate steep decline in prices depends on how long the downturn lasts and how involved the rest of the economy becomes. [In the late 1980s] there was a sharp, sharp downturn in the New England economy that coincided with the beginning of the price decline, and they fed on each other. That's a big difference between where we are today and where we were then. We don't have a recession going on, at least yet, we have low interest rates still, and demographics that are not terrible. So there are arguments for why this should come out OK.

How do people who aren't planning to sell their homes react to knowing it's worth less? Might they cut back on spending and hurt the economy?
I did a paper with John Quigley at Berkeley and Robert Schiller [author of "Irrational Exuberance"] at Yale that addresses that point. We found there's a positive and significant wealth effect from rising home values. [But] a declining housing market doesn't seem to have an

effect—it's asymmetric. On the way up, people tend to spend more, then they keep spending even when prices go down. [But there's also] an income effect that results from the decline in income being generated by the real estate sector. Right now I think that's our biggest problem. My worry is that in the spring of next year, there's going to be a significant decline in employment among real-estate agents and brokers and mortgage bankers ... The people who sold them restaurant meals and cars when they were doing well are not doing the same business, and then they lose money. It's a multiplier.

When people look back on the early 2000s housing boom, what will make it different from previous booms?
The incredible size of the asset buildup. Since 2000, the value of residential real estate has risen in value from $12 trillion to $25 trillion. Some of that is from the building of new homes and from renovations and repairs. But it's also the rising value of existing homes. The total financial wealth of the household sector is $40 trillion, and for home values to have gone up by more than $10 trillion in five years, the magnitude is enormous. It's like the law of gravity; it has to bite sometime. Then we get into a debate about how deep and how long. It's an inevitable downturn. The only question is how deep and how long.

OK, how long and how deep?
I don't know. I think we'll see declines in volumes that will be very painful. I don't think we'll see a huge crash in prices, but prices will go down. If prices went down more than 15 percent, that'd be a big bang. That's about what happened in New England last time. If that happens and we ride it out, we're going to be fine.