

## **The Dot-Home Bust: Trends in Housing Prices and Their Economic Implications**

There is nothing equivalent to a stock market average for housing prices. Because of that one cannot point to a date when the housing market peaked in the manner of the dot-com bust in 2000 which rang a bell when the Nasdaq index hit 5048.62 on March 10. Still, there is mounting anecdotal evidence that housing prices have peaked, and will not be resuming their former levels of appreciation for quite some time.

Like all bubbles, the peak in housing prices was driven by an abundance of credit and a relaxation of the standards as to how it was allocated. In the housing market the looser standards for loan qualification were compounded by a number of new mortgage products that offered low initial payments in exchange for the potential to have the payments adjusted upward should interest rates rise.

Currently most of the damage to home lending is occurring in the so-called sub-prime market. These were borrowers that previously would not have qualified for mortgages and would live instead in rental units or mobile homes. In recent years such borrowers were qualified for mortgages using lower standards of suitability in terms of income and net worth.

The incentive to make such loans came from lenders acting as agents for companies that packaged and sold the mortgages to others as high-yielding income investments. Since the initial lender did not hold onto the loan, their concern for the long term was mitigated by the fees earned for arranging the loan and selling it to a third-party investor. Some of these lenders did promise to buy back the loans if they went bad during an initial period. Such promises are prompting a number of mortgage originators to seek bankruptcy protection, abandoning their promise to honor any shortfalls in the process.

This brings up the current speculation: who will be left holding the bag? Reliable data is hard to come by, but estimates of soured sub-prime loans are as high as 15 percent. If most of these loans were sold off to third parties, who are the current owners? Suspects include high-yield bond mutual funds, pension plans, hedge funds and the like. Some banks hold such loans, but their exposure is minimal relative to their total volume of loans outstanding.

The public is asking if the defaults in sub-prime loans will spread to other parts of the housing market. The answer is yes and no. While there is not yet any evidence of excessive defaults by more qualified borrowers, a return to normal default rates will be an increase after the levels experienced in the past five years. Adjustable rate loans are less of a mainstay among more qualified lenders, making them more immune to the recent increases in interest rates. Conventional borrowers were more likely to put 20 percent or more down on their homes, which gives borrowers more of a hedge when home values soften.

Among qualified lenders, the most vulnerable are those who used either mortgage refinancing or equity lines to take equity out of their then appreciating property for the purpose of personal consumption such as a vacation cruise or more exotic car. Also considered consumption are home improvements that typically are not recovered upon sale such as a swimming pool or wine cellar. The purchase or expansion of a home that contains more square footage than the average person needs may suffer given the trends towards smaller homes promoted by demographic factors of empty nesters and people staying single for longer periods of time.

The idea of a home as a rapidly appreciating investment is a relatively new one. Real estate has historically held its value well against inflation, but it was inflation that drove home prices upwards. Outside of scarcity factors such as access to schools or exclusive parts of town, homes have as a group reflected replacement cost which is a function of land value and cost of materials and labor. Too, home prices do not typically reflect the amount spent on maintenance and upkeep, which homeowners tend to set aside when considering home returns.

The prospects for home prices going forward are a bit subdued. In favor of higher prices is population growth, although the rate of growth is decelerating due to tighter immigration rules. Location is still a factor in real estate, with the Sunbelt continuing to attract people from other parts of the country.

Holding back higher home prices will be the return to earlier underwriting standards. A requirement of 20 percent down, steady employment and evidence of the ability to repay will put housing out of reach for many, or will result in more modest home purchases. The absence of such buyers will prevent existing homeowners from getting enough equity to trade up, causing a ripple effect in the higher price points.

In terms of the bigger picture, the housing correction is not expected to have enough of an impact to cause the economy to stall. The increase in mortgage defaults seems to be focused in a specific sector. It will change consumer spending habits. About \$313 billion was taken out of home equity during refinancing in 2006. This is not about to be repeated for some time. However, other sectors such as defense, health care, etc, are expected to provide enough momentum to keep the economy on an even keel.

## **The Economy**

Economic activity continues to post positive numbers. The slowdown in housing and related industries is being offset by non-residential construction as well as government spending for defense, health care and education. Also, export industries such as capital goods and farm products are showing healthy year-to-year comparisons.

There has been a concern voiced about the health of foreign economies, especially after the stock market correction that occurred last month. However, prices paid for industrial raw materials for physical delivery (as opposed to speculation) such as copper, nickel, steel and the like are still very firm. Also, international shipping rates are showing no signs of discounting, which would normally presage a slowdown in economic activity.

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## **Interest Rates**

The speculation on lower interest rates continues among market commentators and investors without any foundation in fact. Economic activity is still too strong and inflation forces are too active to justify an interest rate cut for all except political reasons.

Many investors believe that lower interest rates would revive the housing market and consumer spending in the process. However, as the cover article pointed out, lax underwriting standards have been more of a factor in the housing market in the past few years than interest rates. Lower interest rates did encourage mortgage refinancing and withdrawal of equity that was sometimes spent. However, given the current inflation forecast the odds of materially lower mortgage rates are probably pretty slim. If anything the odds would support mortgage rates rising as opposed to falling.

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## **Inflation**

Inflation numbers are coming in higher than forecast. This would suggest that most investors and commentators are depending too much on recent history to make their inflation forecasts.

Sources of higher prices range from ethanol, which is pushing up the cost of food, to labor, which is obtaining higher compensation than the inflation rate for the first time in several years. This compensation gain reflects the lack of qualified workers as well as the accelerating number of retirees due to the demographic shifts in the population. Accelerating the population shift are the restrictions against immigration being driven by both national security and political considerations.

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### **The Stock Market**

After the market spill last month the stock market seems to be trying to make headway on the back of several takeover deals and merger offers. While such activity can lend support to a market, it may not be enough to propel stocks upward in the manner seen in 2006.

Within the stock market there seems to be an aversion to companies that deal in the housing sector or its consequences such as finance, furniture and home improvements. Sectors doing well are those linked to health care, defense, and transportation.

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