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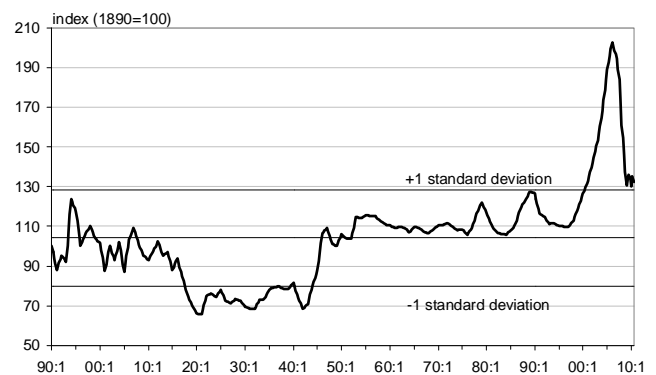
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- *Investors are correct to be concerned about the risks posed by an additional decline in house prices. Nevertheless, those risks have been exaggerated. Ongoing pressure on house prices is a headwind for growth, but there are many signs these pressures are diminishing. Falling house prices are unlikely to derail the expansion now underway.*

If all the economists in the world were placed end to end, they would not reach a conclusion. Despite this, most economists today agree that a significant decline in house prices continues to be a major threat to the economic outlook. It is, therefore, important to assess the seriousness of this threat.

The most worrisome indicator is shown in chart 1, produced by Robert Shiller and recently reproduced in a letter published by the Dallas Federal Reserve Bank. The argument is that if house prices revert to their long term mean, an additional 20+% decline is in store. However, this metric is not likely to be especially helpful in gauging the future path of house prices. First, this series does not show strong mean reversion tendencies like other data series that fluctuate above and below the mean. Instead, it shows strong tendencies to remain above or below the mean for extended periods. Second, analysts have noted the data itself is flawed for at least the late 1960s and 1970s. Shiller uses data contained in the CPI-U where the home purchase component was significantly biased down. As a result, the mean is biased down, causing the 20+% gap to be overstated. While the chart does a nice job of illustrating the house price bubble that developed in the mid 2000's, now that prices have dropped 33%, complete reversion to the mean is not likely to be a good forecasting assumption.

Chart 1
Real Home Prices



Source: *Irrational Exuberance*, 2nd ed., by Robert J. Shiller, Princeton, NJ: Princeton University Press 2009. Updates by author.

Chart 2
House Price to Rent Index

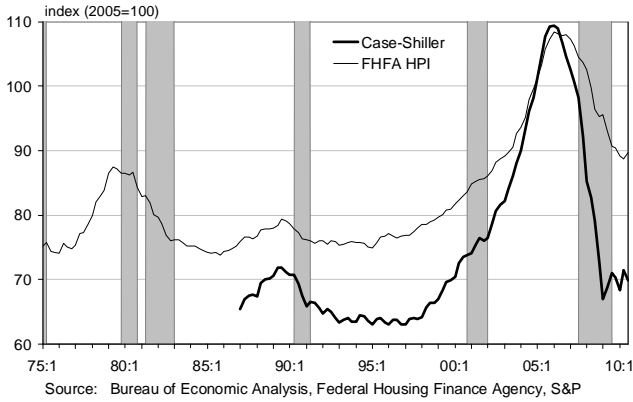
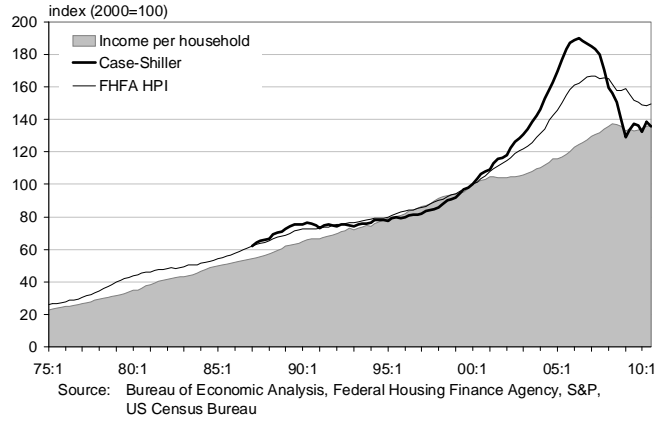


Chart 3
House Price vs. Income Index



Charts 2 and 3 show additional metrics often used by housing analysts. The first shows house prices relative to rents, while the second shows prices relative to income. Two house price indexes are shown – one is published by Federal Housing Finance Agency (FHFA) and the other is the 20 city Case-Shiller index (which does not cover the 60s and 70s). Both series use repeat transaction pairs which provide a good estimate for constant quality price changes and both exclude condos, coops, and multifamily buildings. There are also significant differences between the two measures. The FHFA measure is based on mortgages purchased by Fannie Mae and Freddie Mac. As a result, it under represents prices of houses too expensive to be financed by conforming mortgages. In the early to mid 90s, it also under represents houses financed by subprime mortgages because the agencies purchased very few subprimes. The CS index does not have these coverage problems, but it has geographic coverage limitations. It focuses on 20 cities, and omits large non-urban areas.

Whether one uses rent or income metrics, the FHFA index suggests additional price declines of about 10% are necessary to return to historic relationships. The CS index suggests historic relationships have already been restored and additional declines are not necessary. One explanation of the difference is there may be more downward pressure on moderately priced homes than on more expensive ones. This reflects the fact there has been little or no gain in the value of ‘starter’ homes for a number of years. These gains have typically provided down payments needed to move up into more expensive housing. Without this source of funds for larger down payments, the demand to upgrade suffers.

While rent and income metrics suggest the range of future house price declines is likely to be roughly 0 – 10%, a variety of other measures provide an optimistic bias to this interpretation. For example, the inventory/sales ratio for new houses at 8+ looks high on a historical basis; but builders have stopped allowing this ratio to decline. After reducing inventory levels from mid 2007 to early 2010, builders held new construction very close to the sales rate for the past year. The absolute level of inventory is so low, it will take only a small increase in sales to cause the I/S ratio to plunge (chart 4). At this point, further declines in house construction are a low probability.

Chart 4
New Homes Available For Sale
completed and under construction

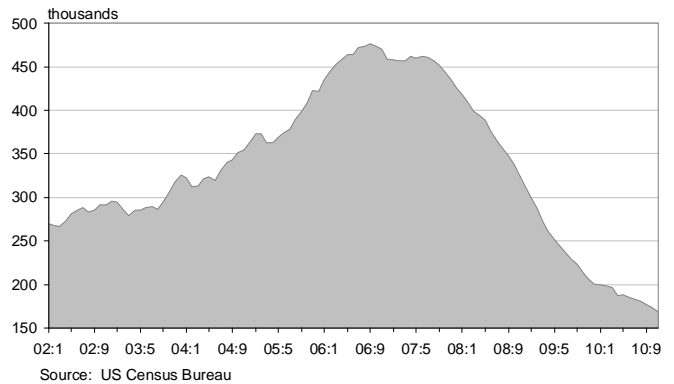


Chart 5
Housing Turnover
share of housing stock sold



Chart 6
Loan Refinancing

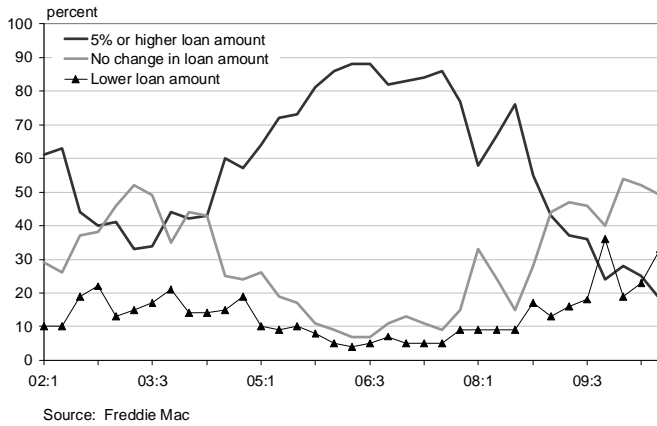
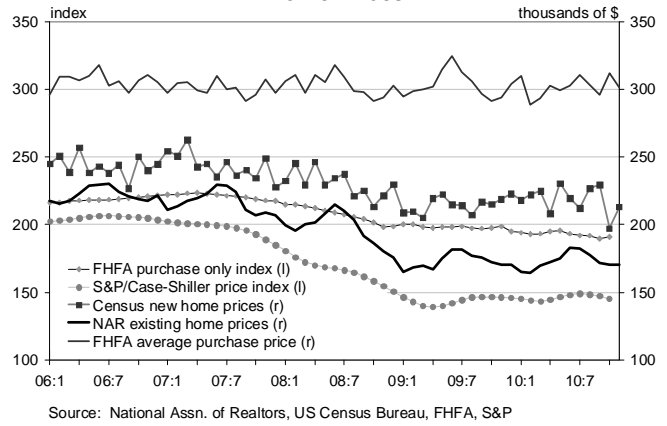


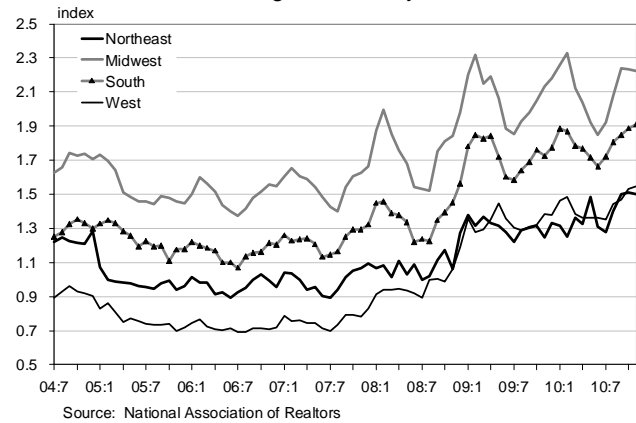
Chart 7
Home Prices



Housing turnover has returned to a 20 year low (chart 5). Slow house turnover reflects softness on the demand side of the house market and therefore tends to put downward pressure on prices. As labor markets gradually improve, job related relocations will encourage some increase in housing turnover. While we do not expect this to improve quickly, the worst downward pressure from this source has probably passed.

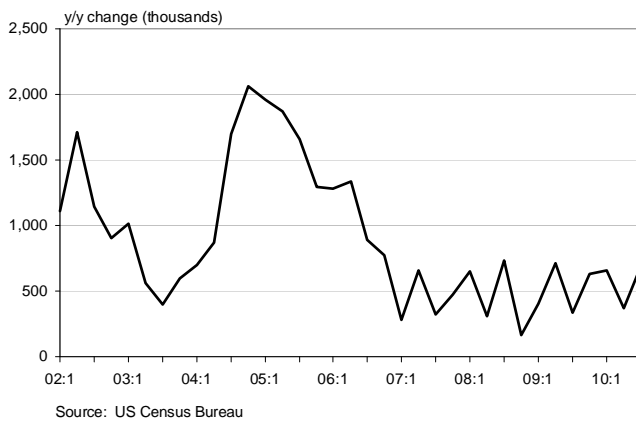
One moderately encouraging fact is many owners began putting money back into their homes in 2009 and 2010, after extracting equity for a sustained period (chart 6). For many, this was necessary in order to refinance since the value of the property had declined. Owners would be reluctant to put new money into property if they expect their equity to be decreased by further price declines. A variety of house price measures have been fairly stable for the past two years (chart 7). This change in behavior represents a vote of confidence in house prices by many current owners.

Chart 8
Housing Affordability Index



As house prices and interest rates declined, housing became more affordable for a larger number of households (chart 8). Nevertheless, the expectation of additional price declines and the scarcity of credit outweighed improvements in affordability. As confidence in price stability improves and credit becomes more available, the improvement in affordability (which has already occurred) will help support aggregate demand.

Chart 9
Household Formation



A key factor in housing demand is the number of new households formed each year (chart 9). This is volatile and quite sensitive to employment conditions – people who cannot find jobs do not form new households. So it is not surprising the level of new household formation was quite low during the recession when jobs were contracting. ‘Normal’ household formation falls between 1 - 1.5 million units; for the past four years, it has fluctuated around 0.5 million. This suggests a substantial amount of pent up demand will emerge as economic and job conditions improve. Because household formation data is poor quality, very volatile, and reported with substantial lags, this is an area where analysts could be surprised with larger than expected increases.

Chart 10

Foreclosures and Defaults

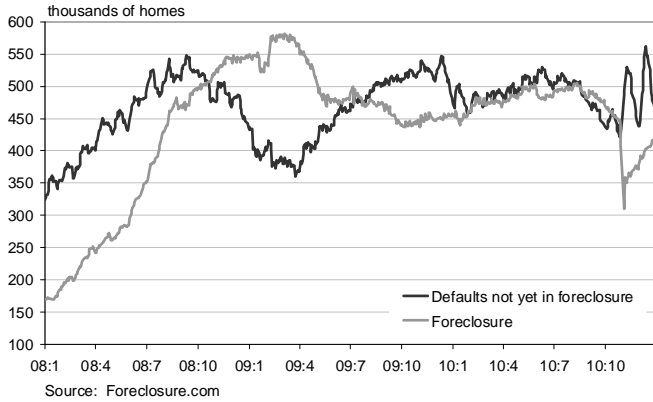
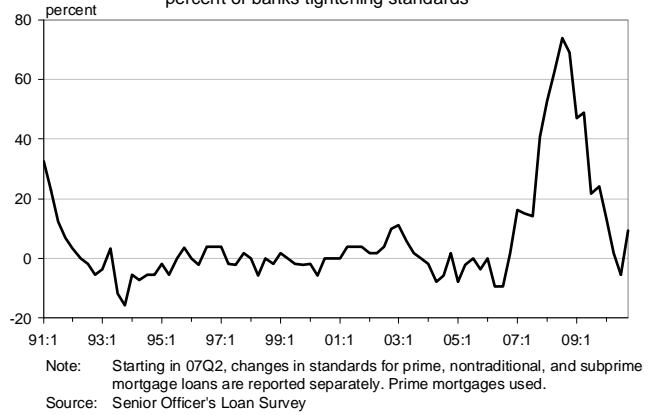


Chart 11

Mortgage Lending
percent of banks tightening standards



One of the most under appreciated causes of downward price pressure has come from credit constraints. A simple example can illustrate the problem. Suppose houses cost \$100 and buyers need a \$10 down payment. Potential buyers will be saving for their down payments and at any given time will hold amounts ranging between \$0 and \$10. If this requirement is suddenly reduced to \$5, there will be a number of potential buyers with \$5 or more who can suddenly purchase houses. This will increase demand relative to supply and put upward pressure on prices until more houses can be built. This is basically what occurred between the mid 1990s and the mid 2000s. The development of the subprime lending industry, credit scoring, and other financial innovations reduced down payment requirements and expanded the pool of potential homebuyers, putting upward pressure on both construction and prices. Of course, the process works in reverse when credit constraints reduce the number of potential homebuyers, but it is not symmetric. It is much easier and quicker to expand the supply of housing than to shrink it. Vacant houses sit vacant, they do not vanish from the market in large numbers. As a result, credit constraints have made a major contribution to price declines and foreclosure problems spawned by reduced home values.

There is little positive to say about the foreclosure problem. As chart 10 shows, foreclosures remain very high and mortgages in default but not yet in foreclosure suggest this will continue for a sustained period. Nevertheless, this is a continuing source of downward price pressure, not a new one, and there is no evidence of significant incremental increases in the number of foreclosures. The part of the story that is changing is credit availability. As banks have written off large amounts of bad debt, their willingness and ability to make new loans has improved. This is illustrated in chart 11. Lending standards will not return to those of 2004 or 2005, nor should they. However, many potential homebuyers have already been squeezed out of the market. It is only necessary for this process to stabilize. Improving credit market conditions appear poised to make a substantial positive contribution to solving housing problems.

To summarize, investors are correct to be concerned about the risks posed by additional declines in house prices. However, these risks have been exaggerated. Ongoing pressure on house prices is a headwind for growth, but there are many signs these pressures are diminishing. Falling house prices are unlikely to be large enough to derail the expansion now underway.

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