BARRON'S

Monday, July 14, 2008

BARRON'S COVER

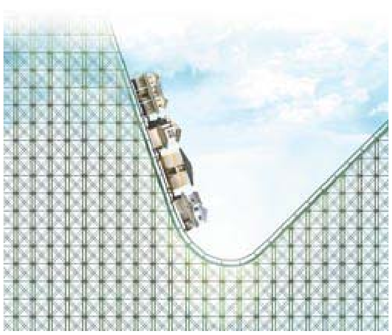
Bottom's Up: This Real-Estate Rout May Be Short-Lived

By JONATHAN R. LAING

This real-estate rout has been more painful than prior ones, but it may be shorter-lived. Indeed, there are early signs of recovery.

A FEW YEARS AGO, AN ACQUAINTANCE SENT Wellesley College economist Karl "Chip" Case a T-shirt depicting a cartoon of a smiley-face house surrounded by soap bubbles, called "Mr. Housing Bubble." But it was the words captured in a comic-book cloud on the shirt that gave this otherwise goofy image its bite: "If I pop, you're screwed!"

The dark humor hardly was lost on Case, co-creator along with Yale economist Robert Shiller of the now-canonical S&P/Case-Shiller Home Price Indices. In pairing recent sale prices of U.S. homes with the prices those same homes fetched previously, the index is substantiating what every sentient American knows: The U.S. housing market is in a deep funk, probably the worst in 50 years, according to Harvard's respected Joint Center for Housing Studies.



Home prices are down nearly 18% from the market's peak, according to Case-Shiller, and inventories of unsold homes are at near-record levels. Foreclosures are mushrooming on "subprime" properties, or homes whose purchase was financed with subprime debt. Blowback from the crisis has left mortgage-finance giants **Fannie Mae** (ticker: FNM) and **Freddie Mac** (FRE) financially strapped, while many other lenders lack the stomach -- or money -- to offer new mortgages. Noted market experts such as Pimco bond-fund manager Bill Gross and economist Mark Zandi of Moody's Economy.com predict the meltdown in housing will continue for many months, with home prices declining by 10% or more from today's depressed levels.

Yet, such pessimism appears overdone, based on much recent data. Sales of existing homes are showing tentative signs of increasing, while the plunge in prices likely is nearing an end. Total inventories fell in May to 4.49 million existing homes for sale, or a 10.8-month supply at the current sales pace, down from an 11.2-month supply in April, according to the National Association of Realtors, in just one statistic emblematic of the nascent trend.

YES, THE SUPPLY OVERHANG still is humongous, but at least the numbers are moving in the right direction, as even Treasury Secretary Henry Paulson noted last week. Speaking at a Federal Deposit Insurance Corp. conference, Paulson declared that "we are well into the adjustment process." Inventories of new single-family homes are down 21% from a 2006 peak, he observed, while "existing-home sales appear to have flattened over the past several months, indicating that demand may be stabilizing."

Still other numbers suggest prices are close to bottoming. The S&P/Case-Shiller Index for April, released just last month, showed the biggest year-over-year price decline yet, of 15.3%. Buried in the numbers, however, and widely ignored in the media, was the news that home prices actually rose, albeit slightly, between March and April, in eight of the 20 markets covered by the index (Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Portland, Ore., and Seattle). This was in sharp contrast to the readings for March, which showed prices falling in 18 of the 20 surveyed markets. Also, the pace of monthly price declines is starting to slow in most of the markets with negative readings.

"Other than Larry Kudlow of CNBC, none of the journalists who interviewed me after the latest release seemed at all interested in any of the positive developments," says David Blitzer, chairman of the S&P Index Committee. "They seemed focused on the bad year-over-year number."

In general, transaction-based home-price indexes, including S&P/Case-Shiller, may be painting a bleaker picture of price trends than warranted. That's because subprime housing, though less than 10% of the total U.S. housing stock, accounts for a far larger share of current sales volume, owing to spiraling defaults and distress sales. In the San Francisco area, expensive homes ($721,548 and up) have suffered a peak-to-trough drop in price of only 10.7%, compared with low-priced homes ($473,711 and under), down 40.9%, and mid-range homes, down 28.3%, according to the latest Case-Shiller numbers. The surge in low- and mid-range sales has been sufficient to push average peak-to-trough prices down by 24.6%, despite the index's valuation-weighting.

Help for the housing market also may be on the way in the form of proposed congressional legislation that would allow the recasting of some $300 billion in troubled subprime mortgages through the Federal Housing Administration. The bill, which some have derided as a bailout, would demand sacrifices by both lenders and borrowers, and could help to ease conditions in the subprime market.

Of greater importance, a government takeover of loss-ridden Fannie and Freddie -- the subject of widespread speculation late last week -- would ease concerns about the continued availability of credit in the housing market. Fannie and Freddie, which buy mortgages from banks and repackage them into mortgage-backed securities, are the biggest source of financing for the U.S. mortgage market.

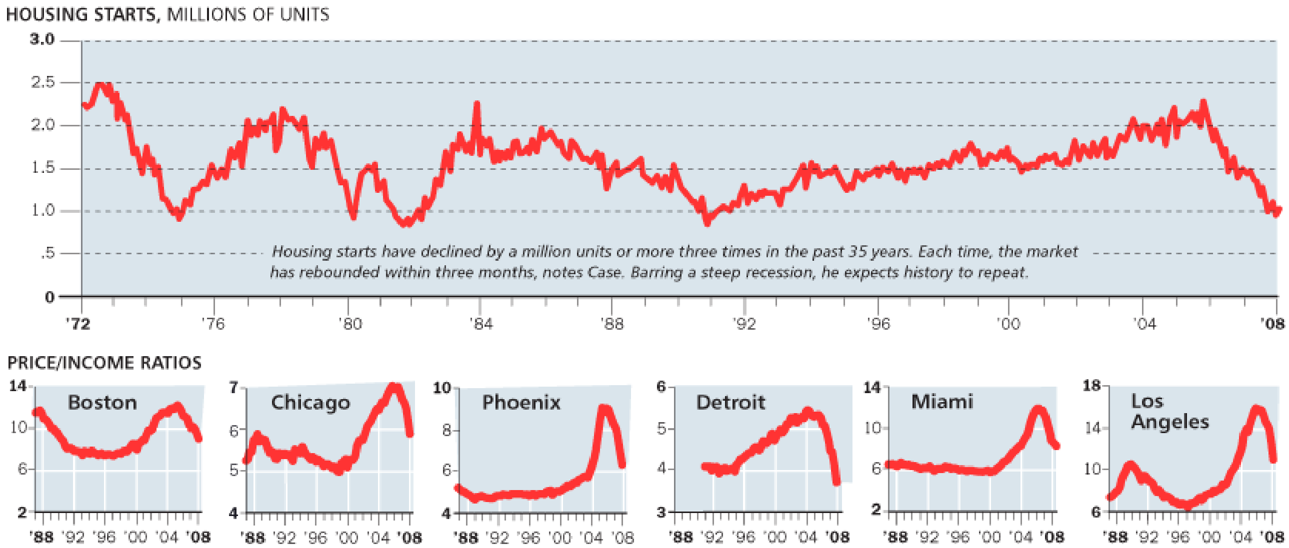
SURPRISINGLY, CHIP CASE, whose knowledge of the housing market goes back decades and is based on the voluminous collection of data, is among those who think home prices may be nearing a bottom. Case notes, among other things, that new housing starts fell to 975,000 in April from a peak rate of 2.27 million in January 2006, and that three declines of similar magnitude -- from more than two million to less than one million -- have occurred in the past 35 years. "Every time this has happened before, housing-market activity has rebounded within a quarter and caught experts by surprise," he says. "In many areas, particularly outside the overbuilt markets of Arizona, Florida and Nevada and the huge bubble market of California, home prices may well stabilize" and begin to recover before the end of this year.

Case acknowledges history might not repeat, as the U.S. could be on the cusp of a painful recession. Unlike the three prior dips of a million-plus starts -- in the first quarter of 1975, the second quarter of 1982 and first quarter of 1991 -- the latest slide was triggered by insensate speculation and suicidal lending practices rather than the traditional factors of rising unemployment and interest rates and slowing economic growth. Thus, he says, a protracted dip in the economy would temper his optimism, though the official measures of economic growth don't indicate a recession yet.

Jim Paulsen, chief investment strategist of Wells Fargo's primary investment unit, expects home prices to steady by year end, with the pace of foreclosures slackening shortly. Most of the subprime debt at the center of the current crisis already has been written down by financial institutions, he notes, while many subprime borrowers who lost their homes are returning to rental units. "Folks who compare this home-price cycle to the one that occurred in the early '80s obviously have short memories," Paulsen says. "In the 1980s the economy was in a deep recession, mortgage rates were at 17% or more, and unemployment [was] hitting a post-Great Depression high of nearly 12%."

THE STEEP DECLINE IN HOME prices -- Case prefers to study the ratio of sale prices to per-capita income in various locales -- already has improved affordability. The change in such ratios varies by market, with Florida, Arizona and Nevada typically tracing short boom-and-bust cycles because any surge in speculative demand quickly is followed by overbuilding, due in part to the abundance of cheap land. The ratio in Phoenix, for example, has been reverting to a more typical six times home prices to income, after soaring to nine times in 2005 and '06.

Most volatile are popular metro areas, such as Los Angeles and Boston, where housing demand is high, along with restrictions on development. Los Angeles' affordability ratio doubled from 2001 to 16 times at the height of the housing boom, before dropping back to around 11. The Boston market never grew so frenzied, perhaps because it was far from the center of the subprime-lending business in Southern California, where an array of bad business practices flourished. Boston's housing-affordability ratio peaked at 12, and since has returned to a more normal nine times prices to income.



Sources: U.S. Census Bureau, S&P/Case-Shiller, BEA, Moody's Economy.com

Building a New Foundation: The U.S. housing market typically begins to improve after housing starts have fallen by a million units or more, says economist Karl "Chip" Case, co-creator of the S&P/Case-Shiller Home Price Indices. Case measures the affordability of homes in various markets via the ratio of home prices to per-capita income. Such ratios rose to excessive heights in recent years in many metro markets, but lately have reverted to more normal levels in cities like Boston and Phoenix.

For much of the country, particularly in the industrial Midwest, affordability never became a problem. In Detroit, for instance, a race to the bottom between home prices and per capita income left the ratio at under four times. Chicago's ratio likewise has been well-behaved, bobbing between five to seven times.

Now sales activity seems to be picking up. According to the latest report from the National Association of Realtors, sales of single-family homes, condominiums, town houses and co-ops edged up 2% in May from April's levels. That might not sound like much of a jump, but May marks only the second month in the past 10 to have seen an increase.

Much of the gain came from markets such as Sacramento, Las Vegas and California's San Fernando Valley and Monterey County, all regions where lenders were unloading large numbers of foreclosed properties. In Detroit, too, sales are soaring, albeit at median prices of under $30,000.

Cape Coral, Fla., a Gulf Coast city of some 170,000, has been depicted in the New York Times and Good Morning America as Foreclosure Central. Yet, in the past two months year-over-year sales have jumped more than 40% as a result of avid bargain-hunting. So-called 3-2-2-1s (three bedrooms, two baths, two-car garages and one swimming pool) that sold for more than $300,000 at the height of the boom now are being snatched up in bulk by investors for as much as 60% less, says local Realtor Tommy Lee. "I'm telling people to come on down and take a look, but only if you have pre-approved credit, because with gas prices where they are, I don't want to be running a taxi service," he says.

NAR economist Lawrence Yun is optimistic home prices will stabilize in the next five months and begin to recover next year, despite today's gloom and overly stringent lending standards. NAR officials typically are cheerleaders, but Yun advances some reasonable arguments to buttress his view. Home sales, he notes, currently are running at a pace of about five million a year, around the same level as a decade ago. Yet, the population has grown by 25 million in the past 10 years, and the U.S. has created 10 million new jobs. Though the rate of new-household formation requires the net addition of 1.6 million housing units a year, housing starts likely will remain below one million into next year, creating pent-up demand in the years ahead.

TODAY'S HOUSING BUST IS unique in U.S. economic history. It began in good, not bad, economic times, and has proven to be national rather than regional in scale, with markets around the country detonating like Chinese firecrackers between early 2006 and mid-2007.

With the benefit of hindsight, one can discern a concatenation of developments that made the latest cycle almost inevitable. In the aftermath of the 2000 stock-market bust and the 2001 terrorist attacks, and amid heightened fears of deflation, the Federal Reserve drove short-term interest rates to near-historic lows and flooded the nation's financial system with money. Cheap funding spurred a surge in home-buying, and drove the home-ownership rate to a peak of 69% of all U.S. households by 2004, up from 64% a decade earlier.

Prices in many areas began to go parabolic in '04, at the time the Fed began to raise rates. Affordability became a problem in some markets, and cash-out refinancings began to slow. On Wall Street, however, where the securitization of mortgages had become a huge profit center, the demand for new mortgage product was unrelenting. Mortgage brokers and other loan originators were also getting rich off the business, and thus were eager to oblige. By 2005 the mortgage industry had began churning out new "affordability" products that featured low "teaser" rates in the early years of a mortgage to keep monthly payments low. Long-sacrosanct down-payment and family debt-to-income requirements were jettisoned. Other products enabled borrowers to repay interest only in the early years of a loan, while so-called option ARMs added the unpaid portion of monthly interest to the principal balance.

Come 2006, many lenders were scraping the bottom of the barrel to find new borrowers, some of whom, by fibbing about their annual income and net worth, often with the connivance of mortgage brokers, secured "liar loans." As greed gave way to fraud, both borrowers and lenders came to believe that ever-rising home prices would cure any defects in the underwriting process.

All this helps explain the seemingly aberrant behavior of many homeowners once prices started down in 2006. Borrowers with 100% loan-to-value mortgages, particularly after including first and second mortgages and home-equity lines of credit, began defaulting, sometimes mailing their keys, or "jingle mail," to their loan servicers. Why keep paying, after all, once the value of a property has slumped below that of the debt against it? Better to live rent-free until the foreclosure notice arrives. Such behavior also was rampant in Texas in the mid-1980s, when the oil boom went bust.

Delinquencies, defaults and foreclosures hit the housing market with a rapidity and virulence unmatched in previous cycles, pushing total loans past-due and foreclosure rates to unprecedented highs. As a consequence, the current residential real-estate cycle has been front-end-loaded relative to past bear markets, which suggests the pain, though excruciating for many, may be shorter-lived than in the past. Early mortgage defaults have blunted the negative impact of subprime-mortgage-rate resets, which peaked in the spring, and are likely to curb the effect of interest-rate resets on option ARMs and other affordability products, expected to peak between 2009 and 2011. Many of these mortgages already are in the foreclosure pipeline, which will lessen the overhang of foreclosed properties in the future.

Tale of Two Markets

Home prices in highly speculative markets like Las Vegas and Miami have plunged, though they are starting to pick up in some other, less speculative locales.

Metro Area	Peak	% Change Since Peak	% change 2000-March 2008
Las Vegas	Aug. 2006	−27.9	69
Phoenix	June 2006	−26.6	67
San Diego	Nov. 2005	−26.0	85
Miami	Dec. 2006	−25.6	109
Detroit	Dec. 2005	−24.8	−4
Los Angeles	Sept. 2006	−24.4	107
Tampa	July 2006	−23.4	82
San Francisco	May 2006	−22.9	68
Washington D.C.	May 2006	−19.4	102
Minneapolis	Sept. 2006	−16.9	42
Cleveland	July 2006	−13.8	6
Boston	Sept. 2005	−13.0	59
Chicago	Sept. 2006	−10.8	50
Denver	Aug. 2006	−9.2	27
New York	June 2006	−8.9	97
Atlanta	Aug. 2006	−7.9	25
Seattle	July 2007	−7.3	78
Portland	Sept. 2007	−6.5	74
Dallas	Aug. 2006	−5.7	19
Charlotte	Aug. 2007	−3.2	32
Composite 10	**June 2006**	**−17.8**	**86**
Composite 20	**July 2006**	**−16.6**	**72**

Source: S&P/Case-Shiller

THERE ARE SIGNS THAT THE PRESSURE on home prices from foreclosures may wane in the months ahead, says Tom Brown of Bankstocks.com, who studied the performance of the dozens of subprime-mortgage securities that make up the ABX indexes. Precipitous declines in these now-infamous indexes, which track the value of the underlying securities, forced financial institutions around the globe to mark their own subprime assets to market, forcing many to write down billions of dollars, and seek new capital.

The performance of the ABX indexes covering the four crummiest subprime vintages -- those securitized from the second half of 2005 to the first half of 2007 -- shows that the rate of early-stage, or 31- to 60-day, delinquencies has been falling for the past six to eight months, says Brown, depending on the newness of the vintage. This is key, he adds, as today's early delinquencies are the raw material for tomorrow's foreclosures. Fewer delinquencies will eventually mean less of an inventory overhang in the housing market.

Likewise, Brown notes a decline in the percentage of early delinquencies that advance to later states. Both developments tell him the cumulative-loss assumptions on these mortgages made by both the credit-rating agencies and Wall Street could prove far too pessimistic.

One can draw a similar conclusion from the delinquency-inflow trends of other types of mortgages, be they loans backed by home-equity lines of credit or second-lien mortgages from the bubble years. Many have performed horribly, but the rate of inflow of new delinquencies suddenly has dropped in recent months.

An ebbing tide of new delinquencies strongly hints that the worst may soon be over for the housing market, at least in terms of burdensome supply. The pig, in other words, is well along the python's alimentary canal.

In hindsight, the housing bust hasn't been nearly as calamitous as depicted in the media, or as Wall Street's woes might suggest. Yes, people have lost their homes, but more than a few were mendacious mortgage applicants and mere speculators, who eagerly sought out 100% margin loans, only to fold just as quickly when prices turned against them.

It is important to remember, as well, that even after a steep drop in the S&P/Case-Shiller Indices, long-term buyers in the top 20 U.S. metro markets have seen their properties appreciate by 70% since 2000. Home prices often take five to 10 years to recover fully from severe declines such as this. But at least the available data suggest the scary dive in home prices soon will be over.

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