

Making Sense of the Current Real Estate Market: Slowdowns, Foreclosures and the Future

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It's a mess. It's a complicated, expensive, painful mess. And it's still got a ways to go before it becomes untangled. "It" in this case is the mortgage, housing, economic slump currently weighing down on all Americans. It's time to step back, see where it came from, figure out what to do about it and try to predict when it will end.

What Caused It? The Twelve Step Program. The mess didn't happen suddenly like a bolt from the blue. Rather, it came on us gradually, like our expanding waistlines and receding hairlines. Let trace it's evolution through twelve steps:

- Because of population changes and a government drive to increase the homeownership rate, demand for housing grew through the mid-Nineties. Generation X was moving into the labor force, boomers were seeking larger and higher quality homes, and the government was opening the homeownership door to lower income families by using Fannie Mae and Freddie Mac to provide low down payment, low document mortgages. The seeds were sown.
- Taking a cue from the Federal government, private mortgage companies were innovating new instruments that offered low initial rates and required little proof of income for qualification. But, because home prices had yet to respond to the growing demand, these instruments were little used, with the market in the late Nineties still dominated by fixed rate and traditional ARM instruments.
- In the early years of the Twenty-first Century, large national home builders began to evolve from essentially family businesses into public companies. This shift was little noted when it happened but it changed the focus of builders from meeting housing market demand to meeting stock market analysts' expectations.
- The house price-income ratio continued to grow. Historically, this number nationally is about 3, but can vary by region (e.g. in California it is always much higher). When it rises above that, consumers expect it to fall, and hold back on buying. This is a natural market equilibrating mechanism, moderating both booms and slumps. By the beginning of the century, the ratio kept rising, to the point where it became very difficult to amass a down payment. (It should be noted that this was not entirely a function of house prices; incomes were essentially flat in real terms, so that even moderate increases in prices would run by incomes.)
- Now consumers began to feel that they could not afford to stay out of the housing market. In fact, some began to feel that one house was not enough; with prices

beginning to rise more quickly, the short term investment potential of real estate was simply too attractive. They decided to leap in.

- Buyers were able to get into the market more easily because of the exotic instruments that the mortgage industry had invented and now had lying on the shelf. Low down payment mortgages, initial ARM rates well below fully-indexed costs, no documentation mortgages, interest only mortgages, option instruments—all these had the effect of allowing consumers to buy houses easily. They helped low income and young families trying to become first-time buyers (in many cases with subprime credit), homeowners seeking to trade up to more expansive and more expensive houses, and investors seeking to flip houses in a kind of real estate day trading strategy. These latter two make up many of the foreclosures currently plaguing the market.
- The brisk housing market caught the eye of Wall Street, which invented new instruments to shift ownership of mortgages to financial investors through exotic debt instruments (CDOs, SIVs and an entire alphabet soup of risky investments.) In all of this, there was no quality or risk control. Mortgage lenders (who should have been the ones exercising these controls) in effect didn't care who they lent money to or for what. They were in a position to shift all risks to the end user (buyers had to pay off their mortgages or lose their houses) and the end provider (mortgage security holders suffered the loss from defaults.)
- Builders, seeking to profit from the surge of buyers, and at the same time produce revenue estimates that would pump up the value of their stock, began to build large numbers of spec homes. Their activities were concentrated in the hottest housing markets—places where demand had soared and prices were rising at increasing double digit rates. Since a great deal of demand in these areas—Florida, Arizona, Nevada, California—had been created by short term investors—flippers—they were in the position of serving a phantom demand.
- By the middle of 2005, buyers began to withdraw from the market. Their incomes had not increased as fast as home prices, and it became apparent that in many areas, prices had become unrealistically high. Even as buyers withdrew, builders continued to build and sellers, either greedy to capture the paper gains they saw on their properties, or fearful that they would miss the peak of the boom, entered the market in increasing numbers. The result of these actions was increasing inventories of unsold new and used homes in all areas and unprecedented housing gluts in some areas.
- As the housing slump deepened and the subprime collapse began to unfold, the economy began to slow. Employment, which had never been robust during the entire recovery from the recession of 2001, became spotty, with several months of slow growth. Even in the best months, the jobs added were insufficient to keep up with the natural growth of the labor force. The slowing of the economy further

restricted buyers and slowed the recovery of the housing market even in the best regions.

- On top of the subprime failures and the slowing economy, ARMs that had been issued in 2002 began to reprice. Teaser rates had expired and homeowners faced a significant jump in their month housing cost. Many—probably most—were able to roll their mortgages into either fixed rate instruments or new ARMs at teaser rates. Still, their monthly payments rose because rates in 2007 were higher than rates in 2002. Foreclosures, including households with prime credit, rose significantly. The foreclosure rate—although still small in the greater scheme of things—rose 79 percent in 2007 over 2006. And this year, the ARMs issued in 2003 will reprice.
- The troubles in the housing and mortgage markets spread to the greater financial markets as investors watched their bets fail, and companies who had traded in exotic instruments went under. The ripple effects continue.

When Will It End? Despite the intensity of the problems in the housing and mortgages market, this is a normal cycle. We don't see it that way because the upside of the cycle lasted over ten years, from 1995 to the middle of 2005, twice the length of a normal boom. Moving to the downside of the cycle was painful both in absolute terms (many markets just stopped dead) and relative terms (we ceased remembering other downturns). So, this stage of the cycle will be over within the next two years. Helping that turn occur sooner is the strong demand that still exists in the housing market. Boomers are still active as move up and second home buyers and their numbers are being supplemented by the entrance of Generations X and Y as first time buyers. Additionally, continued low rates help. For whatever reason, our international creditors are still accepting our debt paper at relatively low rates. This translates into interest rates (even on traditional instruments) that are still in a range that facilitates home buying. The current economy may be sluggish (and is probably in recession) but if the last two slowdowns are any guide, the slowdown will be short and mild. All in all, the downside of this housing cycle is likely to be over nationally by early 2009.

Of course, there is no national housing market, and every local market will move differently and at different times. In some markets, there is a smothering blanket of inventory, much of it new construction. In these markets, the turn will not come until this burden is removed. These markets will recover later. In other places, the market did not soar into the stratosphere during the upswing, and there is little excess to work off. These markets will come back more quickly. As I mentioned in a previous column, your market will recover as:

1. New listings (compared with the same month last year) fall;

2. Days on the market decline; and
3. The ration of sales price to listing price rises.

When these things happen, roughly in that order, your market is on the way back.

What about foreclosures? Regardless of when housing markets return, we will still have the problem of foreclosures to deal with. With more and more mortgages repricing in 2008 and 2009, we can expect to see the foreclosure rate continue to rise. Think of this as the savings and loan crisis of the 80's. Then, the problem was disposing of the bad assets on the books of failed institutions. The answer was a creation of a government agency that would work out these assets, acquiring them and selling them for a percentage of their book value to private investors. When the assets were removed from the books, the cleansed institutions could then be sold to other financial institutions. It all worked, so well that the government agency created to accomplish the clean up went out of business.

We need now to apply those lessons to foreclosed houses. Banks don't want to own real property, and they are not set up to dispose of it efficiently. A similar government agency (during the Depression it was called the Home Owners' Loan Corporation), charged with the responsibility of acquiring foreclosed property and then reselling it to private investors, could be as effective in getting foreclosed property off the market, allowing housing markets to function normally. Combined with a program of assistance to owners who have lost their property, the new agency could provide the total solution.

A Final Word. This may seem like a tough time in real estate. But those of you who have been in the business for more than fifteen years have seen it all before. Then, you had tolls that would help you get through a housing market downturn. Take them out, dust them off and begin to use them again. Despite all the changes that have happened and continue to happen in the real estate market and the real estate business, the basic always apply.