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Economic Research:

For The U.S. Housing Slump, The Bottom May Be In Sight

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Like grief, a housing downturn is a multi-stage process. Stage 1 is denial: If I hold onto the house long enough, I'll get my price. For the U.S. housing market, this stage began in 2005 and ended in mid 2006. Stage 2 is anger: If I can't sell this house, I'll just cancel the sale of the house I was going to buy, and stay where I am. Cancellations of sales agreements now appear to have peaked. Stage 3 is acceptance: I'll get what I can and move on if necessary. The housing market appears to be just entering that third stage, which will probably continue through the rest of 2007. Sales will stabilize, but until the market finishes stage 3 and gets rid of the excess inventory of unsold homes, home prices will continue to drop.

Getting to stage 3 has been painful. In the current housing slump, starts have dropped to an average annual rate of 1.52 million over the past three months, from 2.07 million in 2005. The median existing-home price is now down 3.1% from a year ago. By historical standards, however, the falloff in housing starts and sales is still moderate: In the average postwar recession, starts have plunged 50% from peak to trough and to a low of fewer than 1 million units. The decline in the median home price, though, is more uncommon, with the first year-over-year drop since the 1930s likely from 2006 to 2007. And homeowners, particularly those with adjustable-rate mortgages, are feeling the financial pressure. Although the economy remains generally strong and unemployment low, higher interest rates are squeezing mortgagees who stretched too far to buy their homes. Foreclosure rates are rising, though they're still moderate by historical standards.

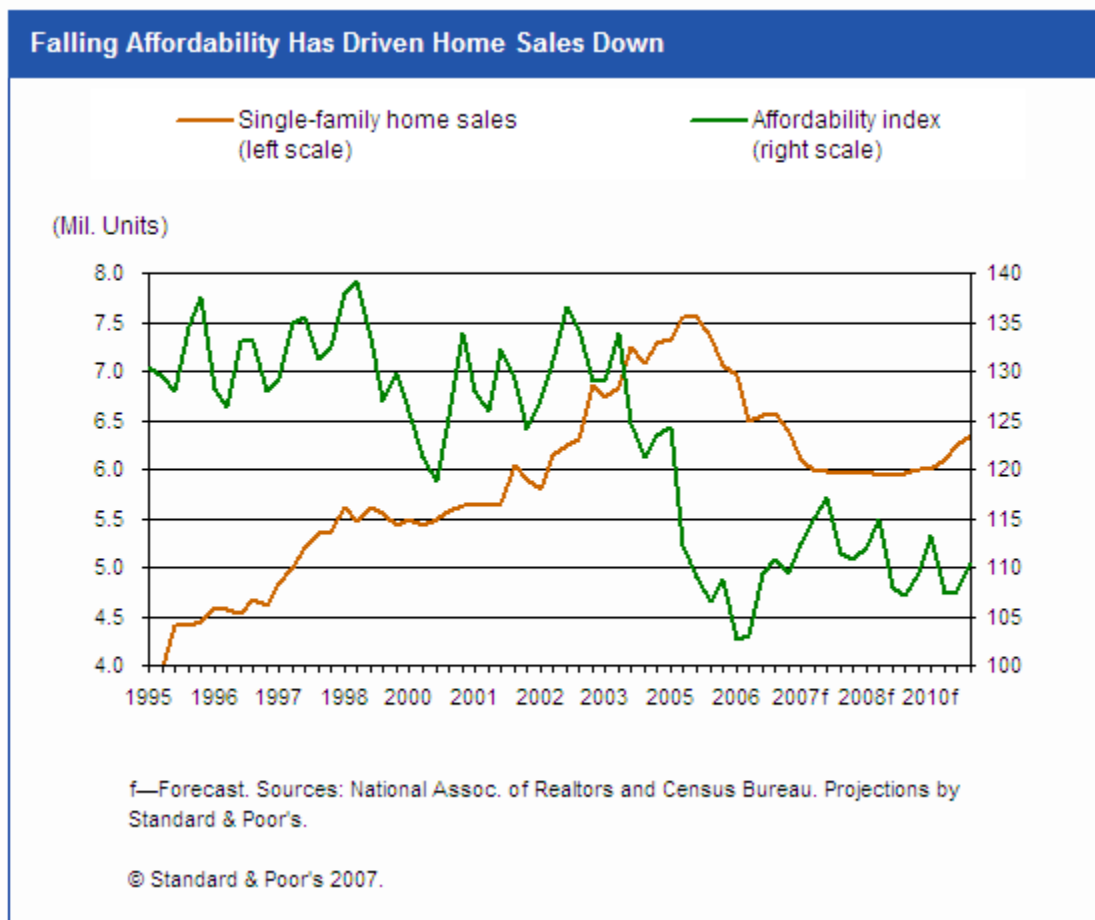
The good news is some tentative signs indicate that the market is bottoming out, at least in terms of sales and starts. The winter is a bad time to look for signs (other than those that say "For Sale") because weather usually dominates month-to-month movements in sales and, especially, starts. Convincing evidence that the housing market has seen the worst won't appear until the spring buying season starts in April. But the early data suggest that starts are leveling out near 1.5 million and existing-home sales near 6.25 million. The inventory of unsold existing homes has come down to 3.55 million from 3.86 million in July.

Homes Are Less Affordable

Existing-home sales rebounded in January, to a seven-month high of 6.46 million (annual rate), but that remains down 4.3% from January 2006 and is 8.7% below the record 7.08 million sales reached in the peak year of 2005. New home sales have been hit harder, plunging to a four-year low of 937,000 (annual rate) in January. That's down 20.1% from a year earlier.

The reason for the decline is that homes have essentially become more expensive (see chart 1). After all, for the average buyer, a home's price is the size of the monthly mortgage payment. As mortgage rates have risen to their current 6.2% (30-year conventional) from 5.5% three years ago, the effective cost of a house has risen nearly proportionately. The change has pushed down the National Assoc. of Realtors's affordability index (which is based on the monthly income required to qualify to buy the median existing home with a conventional mortgage) to 106.5 in the fourth quarter of 2006 from the record high of 136.5 in the first quarter of 2003.

Chart 1



What could improve affordability? For one thing, Federal Reserve rate cuts, which we expect to begin late this year, would make adjustable-rate mortgages cheaper, helping sales and moderating the impact of rate resets on adjustable-rate borrowers. However, just as the Fed's rate increases since mid-2004 have had little impact on long-term bond yields, and thus fixed-rate mortgages, Fed cuts will also have little impact on long-term rates. Rate resets are normally capped in any year and have several more increases to go to catch up with the 4.25 percentage points in rate hikes the Fed has already imposed. Thus, even if the central bank begins to cut rates, resets will continue to push payments up.

A Dubious Record For Home Prices

The most unusual feature of the current housing slump is the drop in the median home price. We expect 2007 to be the first full year in the history of the series (since 1966) that it will decline. In only two cases has the year-on-year price been down even for a quarter.

This comment, however, needs two caveats: First, most past housing downturns occurred during periods of high inflation, which disguised the weakness in home prices. The real median home price (deflated by the CPI) has fallen several times, and the decline we're expecting in this downturn is similar to the drop from 1980 to 1983, when the real median home price slid 11% peak-to-trough.

Second, the pattern of sales in this downturn distorts the median home price. Because mortgage rates are still low by historical standards, sales of starter homes are holding up relatively well. The damage is mostly in sales of trade-up homes. The logic is clear. To trade up to a larger home, the owner not only has to sell his existing home (not an easy task in today's market) but also has to abandon his current low-rate mortgage and take out a higher rate loan. The result is a much larger increase in the monthly payment than normal, and many buyers are reconsidering the whole idea.

A better measure of home prices is the S&P/Case-Shiller Home Price Index, which looks at resales of the same houses and thus is less subject to changes in the mix (see table 1). Although the median home price is down 3.1% from a year ago, the S&P/Case-Shiller index is up 0.2%. However, a weakness in it is that it covers only the 20 largest metropolitan areas. But it is tradable.

Table 1

The Biggest Price Drops Aren't In The Most Overvalued Markets

| S&P/Case-Shiller Home Price Indexes | | |
|-------------------------------------|--|---------------------|
| | December 2006 - December 2005 % change | 2002 - 2005 average |
| Top five | | |
| Seattle | 12.1 | 12.2 |
| Portland, Ore. | 9.9 | 13.1 |
| Charlotte | 6.7 | 4.1 |
| Miami | 6.1 | 23.1 |
| Atlanta | 2.9 | 4.3 |
| Bottom five | | |
| Detroit | (5.9) | 3.1 |
| Boston | (5.1) | 6.8 |
| San Diego | (4.2) | 17.2 |
| Washington, D.C. | (2.9) | 19.5 |
| Cleveland | (2.4) | 3.7 |

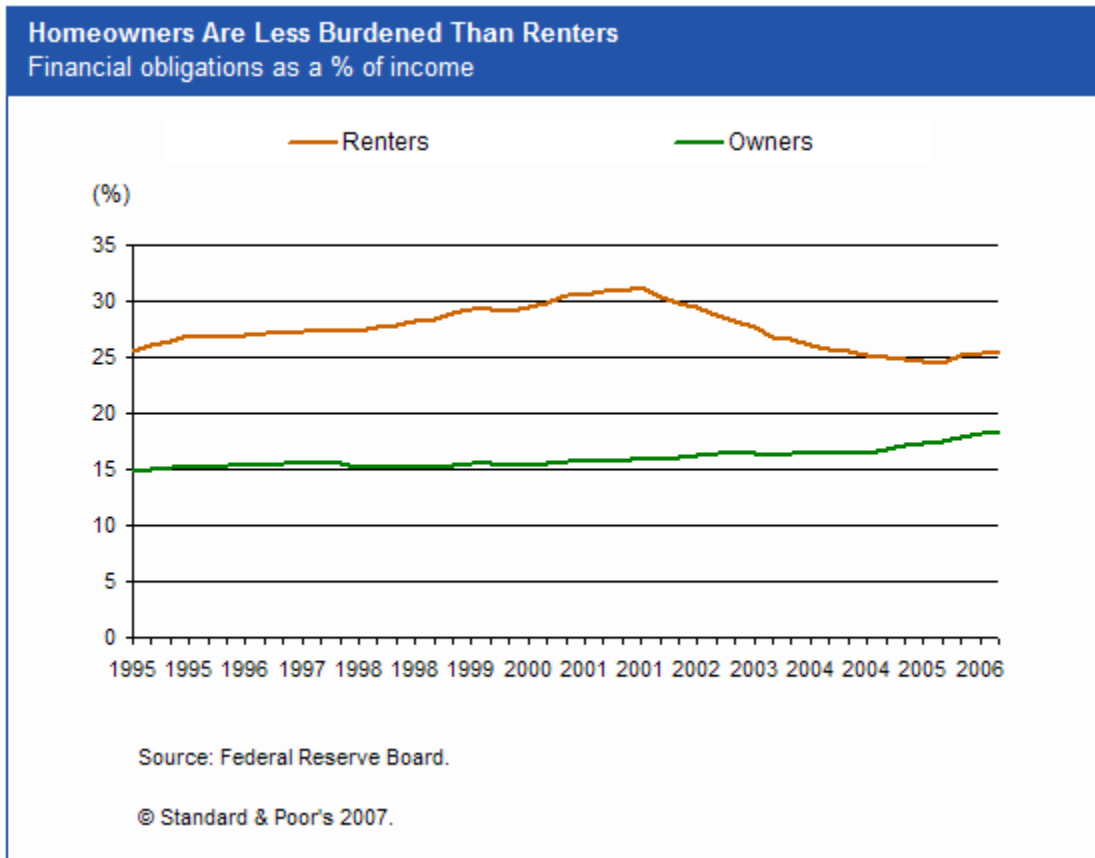
Note that the biggest declines in home prices aren't in the regions that had the biggest run-ups. That distinction for last year belongs to Michigan, where home price appreciation has been weak and the ratio of home price to average income is among the lowest in the country. Because of the auto industry's problems, job growth in Michigan has been subpar, and home prices have dropped accordingly. On the other hand, California has the highest ratio of home price to income, and prices there keep rising because of strong job growth and immigration.

The Impact On Mortgage Holders

One of the biggest concerns the current housing slump has created is that mortgage holders will be unable to pay their monthly bills as rates adjust upward. Although adjustable-rate loans are only 21% of new mortgages, their share of subprime mortgages is twice as big. The higher monthly payments are a strong factor in the rise of delinquency rates, which hit 1.91% in the fourth quarter (for mortgages at commercial banks) from 1.62% a year earlier. The delinquency and foreclosure rates are up sharply but remain well below their historical averages, much less their recession peaks. Delinquencies were running at 2.40% in the second quarter of 2001, just before the Sept. 11 terrorist attacks. The charge-off rate has doubled over the same period but is still negligible at 0.12%. However, because the 4.25-percentage-point rise in short-term interest rates that began in mid-2004 still hasn't completely passed through to mortgage holders, more trouble could be waiting.

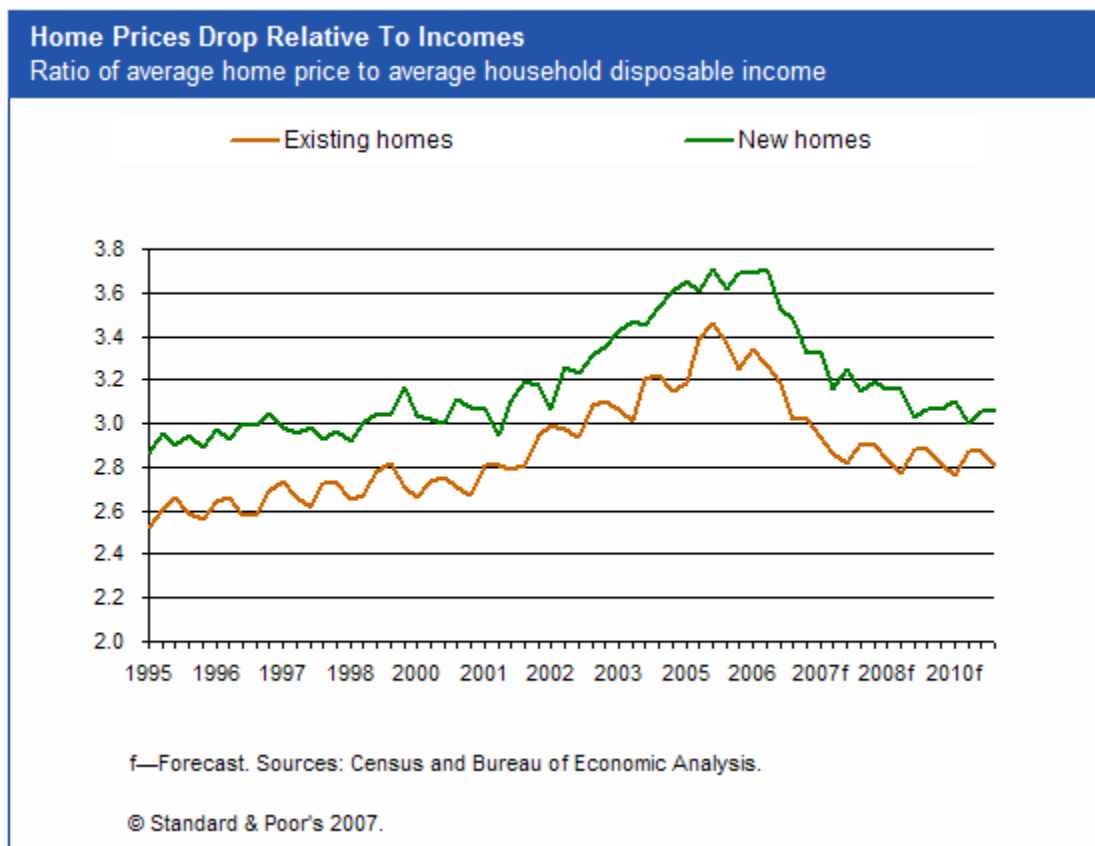
On average, however, households appear to be in good shape. Although household wealth remains well below its 1999 record ratio of 615% of after-tax income, the current 575% is still well above its 1959-2005 average of 480%. Debt-service payments are at a near-record 14.5% of household income, but they seem manageable. Total financial obligations—which include debt-service plus rents, leases, property taxes, and insurance payments—are at 19.4% of income, a record high but up only slightly from the average of the past few years. Moreover, for homeowners, that financial obligation ratio is only 18.2%, compared with 25.4% for renters. Owning a home still beats paying rent in the long run, though not by as much as it did two years ago (see chart 2).

Chart 2



Eventually, we expect the ratio of the average home price to average income to return to near its historical average of 260%. In the fourth quarter, the ratio was 319%, down from a peak of 346% in the third quarter of 2005. We expect the ratio to fall to 280% by the first quarter of next year. The fact that mortgage rates will stay below the historical average should allow the ratio to remain somewhat above its average.

Chart 3



Still, some households are going to be in trouble. The 2004 Federal Reserve Survey of Consumer Finances showed that 12.2% of U.S. households have debt-service burdens that exceed 40% of their income. That's up from 11.8% in 2001. We suspect that this category also has a higher share of borrowers with adjustable-rate mortgages.

The Impact On The Economy

Housing is the major factor slowing economic growth in the U.S. If not for the decline in residential construction activity, real GDP growth in the second half of 2006 would have been 3.4%, about even with the average of the preceding four quarters, instead of downshifting to 2.3%. We expect housing to subtract about a percentage point from growth in the first half of 2007.

The indirect impact of housing on the economy, however, has so far been small. Consumers haven't backed away from spending, with the personal saving rate remaining well below zero (negative 1.2% in February). The strong stock market has offset the lower increase in housing wealth. However, trouble could be around the corner if stock prices continue to fall.

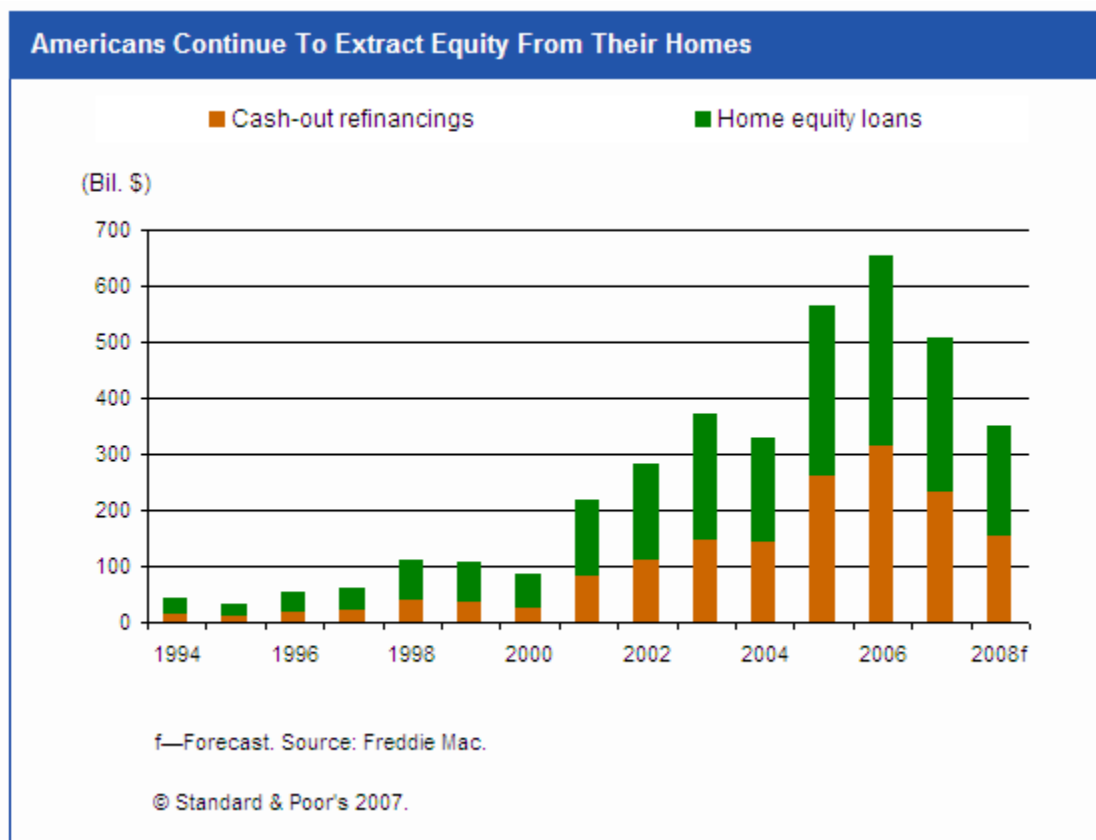
One impact has been lower sales of building materials, furniture, and appliances, which are directly related to home purchases. Building material stores reported a 0.4% sales drop in January compared with a year earlier. Furniture sales were up 1.7%. That's below the 4.3% rise in overall retail sales, but at least it wasn't down. Appliance sales are hard to track because stores that sell them also tend to sell electronics, which have been very strong.

What Happens To Borrowing?

One of the biggest questions is whether the higher interest rates and slower rise in home equity values will trim borrowing. Because of home equity loans and cash-out refinancings, Americans have been using

their homes as ATM machines (see chart 4). Last year, homeowners took \$654 billion (nearly 7% of disposable income) out of their homes. Low interest rates make these loans cheap, especially because they're usually tax deductible.

Chart 4



So far, this activity doesn't seem to be tapering off very much. Refinancings remain high, though some of it probably stems from turning adjustable-rate loans into fixed rates as mortgage holders get the jitters. Moreover, Americans still have a lot of untapped home equity. In fact, the average loan-to-value ratio in the U.S. housing market has barely changed in recent years. It was 46% in the third quarter of 2006, compared with 42% at the end of 2001.

Higher interest rates will probably cut down on borrowing, and thus eventually spending, but interest rates rather than slower home price appreciation will be the major force. Americans have no shortage of ways to borrow and seem determined to use all of them.

Two Economic Impact Scenarios

Our baseline U.S. economic forecast includes a two-year drop of 8% in the average existing-home price from the peak reached in early 2006. Along with the growth of income, this decline brings the ratio of home price to income back to 280% by 2010, still above its long-term average of 260%. If the home-price correction comes faster, however, it could help cause a recession. One possibility: Dollar weakness pushes up bond yields and thus mortgage rates, triggering a quicker drop in home prices.

In our alternative economic projection, we assume that bond yields rise sharply, carrying the mortgage rate up to 8% by the end of 2008. Home sales and prices plummet. The average existing home price tumbles 20% from its early 2006 peak, more than twice the decline seen in the baseline. Housing starts drop under 1 million units, a fairly typical recession falloff, by early 2008.

The decline triggers a recession, starting in the fourth quarter of 2007. The stock market drops sharply in

response to both weaker earnings and higher bond yields, compounding the impact of lower house prices on wealth. The unemployment rate rises above 6% by year-end, instead of peaking near 5%, as in the baseline. Still, the recession is mild, similar to the 2001 or 1991 downturns (see table 2).

Table 2

| If Home Prices Drop 20% | | | | |
|--|-------------|--------------|--------------|--------------|
| | 2006 | 2007f | 2008f | 2009f |
| Real GDP (% change) | | | | |
| Home price drop | 3.3 | 1.8 | 0.3 | 2.8 |
| Baseline | 3.3 | 2.4 | 3.0 | 3.1 |
| Housing starts (mil.) | | | | |
| Home price drop | 1.8 | 1.3 | 1.1 | 1.4 |
| Baseline | 1.8 | 1.5 | 1.6 | 1.7 |
| Mortgage rate (30-year conventional, %) | | | | |
| Home price drop | 6.4 | 6.4 | 7.6 | 7.9 |
| Baseline | 6.4 | 6.3 | 6.7 | 7.2 |
| Average existing home price (\$000s) | | | | |
| Home price drop | 250 | 247 | 222 | 227 |
| Baseline | 270 | 261 | 259 | 268 |
| Unemployment rate (%) | | | | |
| Home price drop | 4.6 | 5.0 | 6.1 | 6.3 |
| Baseline | 4.6 | 4.8 | 4.7 | 4.6 |

f—Forecast.

If The Correction Is Worse

This scenario is intended as a worst likely case. We believe it has about a 10% probability of occurring. The home-price correction would be severe, in fact unprecedented at a national level. However, it would be similar to the size of declines seen in Texas in the mid 1980s or in New England in the early 1990s. Even so, the recession it generates is far from severe.

One exacerbating factor could be the subprime market. There's little question that lenders were too enthusiastic in lending money to people who were stretching to buy houses they perhaps shouldn't have bought. When investors become too complacent about risk and get stung, they often overreact and become too cautious. Legislative actions aimed at preventing foreclosure would increase losses to lenders and drive up the cost of mortgages. That could compound the effect of overcautiousness, by making lenders even less willing to write mortgages. If mortgages are harder to get and more expensive, sales and prices could drop more, and a recovery in the housing market could become very difficult.

Of course, other events, such as oil price shocks or an overall recession, could make economic matters worse in the near future, and any of those possibilities would make our baseline scenario seem benign.

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