Beyond The Bail Out: What's Next in the Housing Market?

The Emergency Economic Stabilization Act of 2008 (we'll call it the "Bail Out") was signed into law on October 3rd. This, combined with the new reality in capital markets and current economic conditions, will result in some major shifts in the outlook for housing over the next few years. It is always possible that the federal government will try to do even more to fix what will be an agonizing housing problem over the next few years, but seems unlikely even Bernanke , Paulson or their appointed successors will be able to change the basic story line.

The Credit Market

Let's set up the dynamics. The era easy credit, especially in terms of mortgages and home equity lines, is over. The 2002 through early 2006 period will turn out to be an aberration in history. During that period, about all a person needed to do to qualify for a mortgage was to be healthy. For the foreseeable future, we will see the return of such requirements as a down payment and the ability to repay your loan based on income, along with a good credit history, that will allow a person to qualify. The tighter credit and the slow down of the economy already is making it difficult for all but the best borrowers to get mortgage loans. Thus, the housing market will remain under significant pressure and the excess supply will be absorbed only slowly.

The Consumer

.Consumers have accumulated far too much debt; they don't have much in the way of traditional savings; are faced with job declines and declines in hours worked and are also facing a reverse wealth affect (i.e. people tend to spend more when they feel richer and less when they feel poorer). In the 1990's, consumers felt wealthier because the stock market did very well. Studies of the wealth effect [1]that people spend about five cents out of every dollar of increased net worth from stock and housing price appreciation over about a three to five year period of time. In the early part of this decade, not only were housing prices rising rapidly, but, almost unbelievably (in retrospect), easy credit allowed people to use their house as a credit card. The result was a boom in retail spending and home buying. In fact, the rate of homeownership in the U.S. went from a long term average of about 65% in 2002, to a high of nearly 69% in 2006. The percentage of people who bought homes, as a percent of total households, reached a record level.

Supply and Demand

Today, there are roughly two million more homes for sale in the nation than normal (4.3 million new and resale listings versus the long-term average of 2.3 million homes for sale). In addition, foreclosures are skyrocketing and are likely to stay high for quite some time. Many recent buyers simply were not financially ready for home ownership's financial realities. Basic demand has diminished significantly as the number of prospects who can qualify has declined. Put all of these things together and you will have a period

[1] http://www.nber.org/papers/w12746.pdf

where not only will there be fewer homes purchased, but there will be high levels of foreclosures, a decline back to the normalized level of homeownership, There will be fewer people moving (i.e. if you cant sell your house in California, Michigan or Pennsylvania, you are not moving to Arizona). What this implies is that the demographic demand for housing will be lower than normal over the next few years until the excess supply is absorbed.

How long will this take? Analysis suggests that it is two to four years away nationally and longer in the bubble states: Arizona, California, Florida and Nevada. All this suggests that as the homeownership rate comes down, more people will be moving to apartments, people will “double up” or move back home. As a result much of the housing demand will be absorbed by foreclosures and the excess existing housing inventory, mitigating the need for significant new housing in the near term.

If you add this all up, this also means slower growth in what were normally rapid growing areas (like Phoenix) where a full recovery could take four to five years for housing. As the home ownership- including condos- rate moves back to its long term trends there will be a shift back to apartments.

Overall, there will be fewer single family homes demanded, more apartments demanded, and the homes that are demanded will be more affordable. The most affordable areas will continue to be at the edge of town. In addition, given how difficult it has been to get the entitlements necessary for new apartment construction in areas like Phoenix over the past several years along with the number of condos that are being converted back to multi-family rentals, rents are likely to increase past 2009 or 2010 as the excess supply of rental single family homes, condos and apartments are absorbed.

Overall homeownership will still be the American dream, but that dream will not again be something people think about until housing prices stop declining and start recovering. It’s going to be a tough ride, particularly in Sunbelt ‘boomtowns’ like Phoenix.