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Research

Housing: Now What?

New York, NY – June 9, 2010 – Opinions about what will happen to housing prices vary widely. One camp of housing market observers believes that steady, if unspectacular, improvement is likely. Others believe nationwide aggregate home prices will drop. Some of the housing bears say home prices will decline slightly - perhaps 3% to 4% over the next 1 to 2 years - while other bears foresee a dramatic second dip in housing prices. In this report we briefly discuss the rationales of housing optimists and housing pessimists, and discuss what we expect to see in the RPX data between now and the end of the year.

What Housing Bulls Say

The principal argument of those who expect home prices to improve steadily is that home prices have already fallen significantly from their peaks and homes are now affordable to a large group of prospective buyers. The decline in home prices over the last 3-4 years has released "pent-up demand" for housing that is more than sufficient to absorb the homes brought to market while keeping housing prices at current levels.

Richard DeKaser, a contributing economist to the Kiplinger Letter, supports the assertion that homes are now extraordinarily affordable by arguing that it now takes 18% of the typical household income to meet principal and interest payments on a single-family home, which compares favorably with the long-term averages of 26%.

Housing bulls also argue that housing credit will become more accessible in coming months and years. They point to the Federal Reserve's April survey of senior loan officers, which shows the majority of banks have reported no change in their lending standards for prime and nontraditional mortgages over the last three months. This is the first extended period in four years in which the majority of respondents have not reported tightening their lending standards.

Bulls also cite improving consumer confidence to bolster their arguments, referring to recent surveys by the University of Michigan that show nearly three-quarters of Americans believe this is a "good time to buy" a home.

What Housing Bears Say

Those who take a bearish view on housing prices point to the large supply of unsold homes, which is augmented by foreclosed homes owned by banks and other financial institutions, and argue that this supply will outstrip demand from potential buyers. They bolster their argument with references to millions of homes

whose owners are delinquent in paying their mortgages, many (if not most) of which could produce new inventory in the form of real estate owned (REO) by financial institutions.

Housing bears also point out that much of the demand that helped to keep home prices stable in 2009 was a product of interventions into the housing market by the Federal Government which have now expired, or are set to do so soon.

Finally, some bears claim that nationwide price-to-rent and price-to-income ratios remain above their long-term averages. The above-average price-to-rent ratio suggests that renting a home is a better deal than purchasing a home. If home prices do not come back into alignment with rents, so the argument goes, people will choose to rent rather than buy a home, thereby reducing the demand for home ownership and contributing to a decline in home prices. Bears argue that the above-average price-to-income ratios indicate housing is still not as affordable as it has been in the past. They say that home prices will eventually have to come back into their long-term alignment with incomes.

The View from Radar Logic

For now, we are taking our place among the bears. Here are a few predictions:

1) *The benefits of the housing tax credit will be temporary.*

Last autumn, the $8,000 housing tax credit helped to delay much of the expected seasonal declines in the RPX Composite price until after the credit's original November 30 expiration date. It appears that the credit motivated people who were likely to purchase a home to do so prior to December 2009. Even though the credit was extended in early November, many prospective buyers had already decided to make their move by then, so the pool of prospective buyers was depleted by December. As a result, the RPX Composite price and transaction count dropped sharply during December and January.

The same scenario is likely to play out this summer, when the deadline for completing home purchases eligible for the tax credit passes on June 30, 2010. We expect the RPX Composite prices and transaction counts to increase in May and June, as seasonal strength is augmented by a rush of activity ahead of the closing deadline for the tax credit. Then the Composite price and transaction count will drop quickly in July and August.

2) *In the second half of the year, a faltering economic recovery will send the RPX Composite price to new lows.*

A number of factors will weigh on the U.S. economy in the second half of 2010, including a decrease in Federal stimulus spending, an increase in household savings at the expense of consumption growth, the economic slowdown in China and Europe and cutbacks by state and local governments. In turn, the downturn in the national economy will weaken demand for housing and further increase the supply of real estate owned by financial institutions, as more homeowners fall behind on their mortgage payments and lose their homes to foreclosure.

3) *Motivated sales and sales at the lower end of the price spectrum will make up a larger share of home sales, putting more downward pressure on the RPX Composite price.*

Sales at the high-end of the home price spectrum will decline relative to sales at the low end of the spectrum, including motivated sales. High rates of negative equity will limit the number of homeowners who can sell their homes, and those who are able will be more likely to move into the rental market or purchase a less expensive home than to trade up into a more expensive home. The activity at the high end of the spectrum will be further limited by tightness in the jumbo mortgage market.

Notwithstanding reports from the FHA, Fannie Mae, Freddie Mac and the Mortgage Bankers Association (MBA) that mortgage delinquencies have slowed in recent months, estimates by the MBA and Zillow indicate that there are still almost 5 million loans more than 90 days past due or in foreclosure. As delinquent mortgages move through the foreclosure process – slowly, for now, but perhaps more rapidly in the near future - the inventory of bank-owned homes is going to increase barring a significant increase in the rate at which banks liquidate their REO inventory via motivated sales. Therefore we expect motivated transaction counts to either remain at their current levels or increase.

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