

“The Homes Keep Selling”

Even Realtors are surprised by the market's strength. But will it last?

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When Laura and John Burgos put their house in Wayland (Mass.) on the market in mid-February, they didn't know how buyers would react to the \$365,000 price tag--a stiff 74% premium over what they paid for the 1950s ranch home less than three years ago. But with 30 prospective buyers trooping through in just the first week on the market, even a realtor who is not working for the Burgos' predicts that "this house will sell in a heartbeat."

Housing, which sagged briefly during the recession, is hot again, and not just around Boston. The latest numbers from the National Association of Realtors (NAR) show that nationwide sales of existing single-family homes jumped 16% in January, to 6.4 million homes, after declining slightly in November and December. Compared with a year earlier, prices of existing-home sales were up 10%, despite a downturn, higher unemployment, and the September 11 terrorist attacks. While some cities, such as Atlanta, Detroit, and Seattle, are still weak, markets have exploded in cities such as Washington, D.C., Miami, and New York.

Is this latest housing boom sustainable, or a real estate bust waiting to happen? The implications for the economy are enormous. New-home sales--more than 901,000 new single-family homes in 2001 alone--pump up homebuilders and creates demand for lumber, carpeting, washing machines, furniture, and all the other things that go into homes. Perhaps more important, rising housing wealth, which increased by roughly \$1 trillion in 2001, puts money into consumers' pockets by means of home-equity loans and mortgage refinancings. That has fueled consumer spending, which has stayed strong despite the weak stock market.

A sharp drop in housing prices, though, could hurt consumer spending as much as price hikes have helped it so far. "The importance of housing market wealth in consumption is bigger than stock

market wealth," says John M. Quigley, an economist at the University of California at Berkeley who did a study on the subject. "If there is a plateau or a downturn in housing market wealth, it could come out pretty quickly in consumption."

That's no idle worry. There's much to suggest that the housing boom is being fueled by unrealistic expectations on the part of homebuyers and by low interest rates on the part of the Fed. Since October, 2001, short-term interest rates have been below the core inflation rate, which excludes food and energy. That makes holding cash or money market funds a losing proposition. At the same time, many investors have been scared away from stocks by the bear market, accounting scandals, and a torrent of downbeat profit reports.

That now makes buying a home by far the most attractive place to put money. But if the economy is starting to recover, as Alan Greenspan suggested in his Feb. 27 testimony to Congress, the Fed will have to begin raising rates. That will cut off the easy money that has been propping up the housing markets and lead savers to put their money elsewhere.

Until that happens, though, consumers are piling on new mortgage debt at a 9% annual growth rate--far exceeding household income growth of less than 4%. And to keep their businesses growing, mortgage lenders appear to be increasingly willing to offer debt to so-called sub-prime borrowers--homebuyers with lower incomes and less established credit who might not have qualified for mortgages in the past. "[Lenders] are taking on higher risk than they have before," says Jack C. Harris, a real estate economist at Texas A&M University.

Demographics, too, may soon start operating against the housing market as older members of the baby boom generation hit their mid-50's. "Baby boomers are emerging from the years

of their lives when they have kids," says Robert J. Shiller, the Yale University economist who correctly forecast the stock market bust. "They may not have the same demand for houses in good school districts."

To be sure, it's nearly impossible to distinguish a bubble from the normal workings of supply and demand until it bursts. And there are certainly plenty of people who believe housing prices can keep climbing. "I don't think this is a bubble waiting to burst," says Kenneth T. Rosen, chairman of the Fisher Center for Real Estate & Urban Economics at the University of California at Berkeley's Haas School of Business.

Optimists such as Rosen expect low mortgage rates, now below 7% for both 15- and 30-year loans, to continue to fuel demand. "A lot of people who were unable to buy in the late 1990s are taking advantage of low interest rates," he says. Meanwhile, a key change in tax law, which took effect in July, 1997, has made real estate investment even more attractive. Home sellers can avoid paying capital-gains tax on up to \$500,000 in profits on the sale of a house as long as they don't sell more than once every two years.

Optimists also point to demographic factors that are sustaining demand. Immigration is continuing at high levels, and the fertility rate has been inching up in recent years as a new generation begins forming families. Meanwhile, tough zoning and land restrictions will continue to limit supply. "We may very well be in a world where growth controls and infrastructure restraints have slowed the market's response to an increase in demand," says Susan M. Wachter, professor of real estate at the University of Pennsylvania's Wharton School of Business.

The return of housing mania has real estate professionals overjoyed and, at the same time, somewhat perplexed. "We continue to ask ourselves what is driving

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this,” says Pat R. Casey, executive vice-president at Bankers Financial Group Inc., a Dallas mortgage bank. “While we haven’t been able to answer that, the homes keep selling.”

Epecially surprised are real estate brokers and mortgage lenders in Silicon Valley, where, despite the continuing tech bust, the housing market has exploded recently after a year and a half of steep price declines. Prices in the San Francisco Bay area have fallen by 1.3% over the last year. The declines in Silicon Valley have been far sharper. Still, “over the last month, the market has gotten hot again,” says Joel Spolin, president of Absolute Mortgage Banking in Palo Alto. “It’s almost like it was 18 months ago.”

Even the beneficiaries of the hot housing market are questioning its underpinnings. “If you had asked me three weeks ago if it would go crazy like this, I’d have told you you had a hole in your head,” says Nancy Mott, a Realtor for Alain Pinel Realtors in Palo Alto, Calif. “My gut feeling is that this may be just another bubble.”

Certainly, housing prices are on a far different trajectory than the rest of the economy. By the measure that the Bureau of Labor Statistics uses, the price of shelter has been rising at roughly a 4% clip, while low inflation or even deflation rules in the rest of the economy. Indeed, according to the Bureau of Labor Statistics, consumer prices, excluding housing, fell over the past year. That hasn’t happened since the 1950s.

Fast-rising housing prices, combined with a low-inflation economy, means that homes are steadily getting more expensive compared with other goods and services that households can buy. Moreover, gains in home prices are outstripping wage gains. That creates a gold-rush mentality in which potential homebuyers rush to grab a house as quickly as possible, even if they overpay.

And mortgage lenders are willing to oblige, even in the case of buyers who might not have qualified before. The average downpayment has dropped to only 5% to 10% over the past decade rather than the 10% to 20% it was in the past, according to Doug Perry, a first vice-president at mortgage lender Countrywide Home Loans Inc. Under the right conditions, Countrywide is even willing to lend homebuyers 103% of the value of their new home to cover their closing costs, too.

In part, the aggressive tactics of mortgage lenders have been made possible by the automated underwriting systems developed in recent years by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These two government-created companies buy 70% of new mortgages in the U.S. and repackage them as mortgage-backed securities, which they then sell to investors.

The new underwriting systems being used by Fannie Mae and Freddie Mac, which are analogous to the credit-scoring systems used by banks, allow for higher loan-to-income ratios than in the past to encourage home buying. That’s good for borrowers, but the relaxed ratios could pose serious problems in the future. For one, there is already evidence that defaults are rising, particularly at the low end of the market, where there is a concentration of homeowners who might not have owned houses without the mortgage boom. The Federal Housing Administration (FHA), which makes low-income loans, saw mortgage delinquencies and foreclosures jump to 0.71% of its portfolio in the middle of last year. “That number has been hanging around 0.59% for years,” says Wharton’s Wachter, who used to work at the Office of Housing & Urban Development (HUD), which collects these statistics. That may not sound like much of a jump, but it amounts to about a \$600 million increase in delinquencies.

For Fannie Mae (FNM) and Freddie Mac (FRE), which only began expanding into subprime mortgages two years ago, deteriorating credit quality may be a new and unpleasant experience. Since they control such a big chunk of the market, if their portfolios are perceived to be more vulnerable to credit issues, that could boost mortgage rates across the country.

Moreover, investors in mortgage-backed securities have always assumed that the two mortgage companies are backed by an implicit government guarantee that investors would be bailed out in the event of big mortgage defaults. But some Republicans in Congress have recently challenged these guarantees. If investors begin to worry that these guarantees won’t be upheld, that could trigger a quick rise in mortgage rates, which would undercut the housing market.

Of course, the pessimists could be wrong, and the housing market could continue to sail upward. But remember that in the late 1990s, few people expected technology stocks to go bust. Now, it’s housing that is supposed to be a no-lose proposition. As the old saying goes: “Fool me once, shame on you. Fool me twice, shame on me.”

By Margaret Popper in New York, with William C. Symonds in Boston, Andrew Park in Dallas, Linda Himelstein in San Mateo, and bureau reports