

## MARKET MONITOR NOVEMBER 13, 2006

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### Has the Housing Bubble Burst?

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If there is one thing that people in higher education and research have in common, it's the cost of housing. As housing prices rose at double-digit rates around the nation, some of us felt we might miss out and this thought only encouraged more buyers to jump in or move up and sellers to keep raising the price bar. Recently, housing prices have retreated sharply, resulting in the first significant national price decline in 11 years and a raft of unsold homes. To many, including those who bought recently or who want to sell now, and especially those who took advantage of interest-only mortgages, it may seem a little like when the Internet stock bubble burst. Are we about to see a precipitous drop in home prices similar to the 70%-80% decline in Internet stock prices in 2000 and 2001?

This week's themes are the following:

- Rising home prices were fueled by low interest rates, a good economy and supportive population changes
- In turn, price rises laid the groundwork for weaker housing demand
- Several mechanisms will prevent the housing price drop from being as precipitous as when the equity bubble burst

So why was housing so strong earlier in this decade? The fundamental answer to that question revolves around three basic forces that happened to converge during that time.

First, mortgage interest rates from 2002 to mid-2004 were the lowest since the late 1950s and early 1960s. With rates this low, new home buyers could now qualify more easily for a mortgage. In addition, a household could buy a more expensive house by taking out a larger mortgage, but not see an increase in its monthly mortgage payment from when interest rates were higher.



A second basic force was the improving economy. By mid-2003, the economy had clearly emerged from the previous economic doldrums. Jobs started to grow at a more rapid pace, boosting household incomes and consumer confidence. Better jobs prospects meant that households had both an increased ability and willingness to buy a home.

Third, population changes also fueled a surge in housing demand. The first children of the baby boomers began to look for housing and new immigrants into the U.S., especially in the South and Southwest, were doing likewise. Even the baby boom generation increased their demand for larger, more expensive homes and for second (and even third) homes.

The confluence of these three fundamental factors stimulated housing demand significantly starting about three to four years ago. And with that sharp increase in demand came outsized increases in national home prices for three years straight. In some localities, the price increases were much sharper than the national averages, reaching 30% annually in certain areas of Florida and California.

This robust pattern also made a significant contribution to the overall economy. Construction, mortgage bank, and realtor jobs flourished. Economic sectors providing materials to the housing industry, such as chemicals, metals, and building materials, also took off. Job growth in these areas further contributed to higher national spending and economic growth. And it was no surprise that paint, carpet, flooring, plumbing fixtures, and other homeowner suppliers did very well during this period.

In addition, rapid increases in the value of homes also improved household balance sheets. With improved net worth, households were more willing to spend on overall goods and services outside of housing, the result of “feeling better” about their financial state generally or having greater willingness to take on more debt to finance increased purchases now that their balance sheets had improved.

While the good times for housing rolled, they also produced excesses that ultimately led to the recent abrupt decline. The biggest excess was the very succession of outsized home price increases, which made it more difficult for many people to afford a home. Home price increases far outstripped general inflation and the growth of consumers’ income. So, even with larger mortgages being taken out and innovative financing products employed (e.g. interest-only mortgages), ultimately affordability became so crimped that housing retrenchment was inevitable. Moreover, beginning in 2004, the Fed began raising short-term interest rates, resulting in higher mortgage rates. Thus, the combination of high home prices and rising interest rates set the stage for bursting the housing bubble. Starting in mid-2005, housing demand and new home starts fell at double-digit rates for the 12 months ended in September this year (over 30% for starts). New home prices have fallen about 10% and existing home sales have slowed considerably.

Most important, the housing decline has been a significant contributor to the recent economic slowdown. Lower housing demand and new production directly detract from overall economic growth and employment. And home price declines adversely impact household balance sheets and consumer spending, especially on discretionary big-ticket items, such as autos. So, basically what we have seen is a deflating housing market, in combination with other factors, pushing economic growth lower.

So, where are housing and the economy going from here? More likely than not, housing demand and production will continue to decline well into next year. Building permits for new housing, a harbinger of future home building activity, continue to decline. And, affordability has yet to see marked improvement, despite mortgage rates somewhat lower and home prices now in modest decline. Therefore, look for housing to continue to cut directly and indirectly into economic growth over coming months.

But will housing suffer the same fate as the Internet stock bubble? We think not, because of the structural

differences between stocks and housing. Changes in the demand and supply for stocks are visible almost instantly in the form of price changes, while changes in the housing market take longer to appear since building, selling, and buying houses are relatively slow processes. In addition, a home has real use value—people can live in their investment while the market fluctuates—which isn't true of stocks, especially Internet stocks. And the Federal Reserve focuses on housing as one of the key drivers of the U.S. economy and understands that interest rate changes quickly translate into effects on the industry. The point is that while there was a housing bubble and it did burst, these special factors should prevent the price fall from being as severe as the internet stock fall.

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