Back *to* Basics

During the recent housing boom, many Americans made unwise financial decisions that boosted demand for mortgages to new heights. Until memories of this nightmare fade, consumers will get back to the basics of using mortgages simply to buy homes. Mortgage bankers, too, must get back to the basics of finding business in markets with the right balance of opportunity and risk.

BY INGO WINZER

In the early 1990s, the end of the Cold War ironically brought economic hardship to Southern California, home to the big defense contractors whose workers built the fighter planes and ships that bankrupted the old Soviet Union. The defense industry had boosted the California economy for decades, and had buoyed the local housing industry. But during the early nineties, defense success gave way to local recession as Pentagon orders receded, airplane production plummeted, and tens of thousands of engineers and machinists found themselves out of work. ■ Seeing no future in an area overrun with other unemployed engineers, many of these Californians left for nearby spots such as Seattle; Portland Oregon; Boise, Idaho; Phoenix; Albuquerque, New Mexico; and Salt Lake City. In two years, more than 1 million people left California. As they left, they sold their homes—some of the most expensive homes in the United States. Over the previous decade, home prices in Southern California had doubled. ■ When these economic refugees arrived in their newly adopted cities, they were pleasantly surprised. Armed with the equity from selling their California homes, they could buy an even better home and still have money left over for a new car, a boat, furniture—the works. Home prices in Seattle were only 60 percent of what they had been in Los Angeles; in Phoenix they were just 40 percent; and in Salt Lake City, only 30 percent. ■ This was the first wave of Americans who, quite by accident, were able to turn homeownership—until then considered an expensive necessity—into a financial bonanza.

A rising tide lifts all boats

Home prices rise in a local market if there is a sudden increase in demand—whether from Japanese investors in Hawaii; pipeline workers in Anchorage, Alaska; financial managers in New York; software engineers in Austin, Texas; or dot-com millionaires in San Francisco. Americans are a highly mobile lot, and will easily move wherever job opportunities present themselves—as the California Defense industry workers demonstrated.

A doubling of home prices, as in Southern California, had been seen before in Texas, Hawaii and the Northeast. These booms—invariably followed by a bust—were isolated phenomena, however, directly linked to the economic prosperity of individual markets. Other homeowners could only look on with envy at annual price increases in the double-digits.

Figure **1** **Home-Price Increases, 2000–2006**

City	Percent
Atlanta, GA	31%
Baltimore, MD	110%
Boston, MA	68%
Charlotte, NC	28%
Chicago, IL	58%
Denver, CO	26%
Detroit, MI	16%
Houston, TX	33%
Las Vegas, NV	118%
Los Angeles, CA	158%
Miami, FL	164%
Minneapolis, MN	57%
New York, NY	97%
Philadelphia, PA	84%
Phoenix, AZ	112%
Sacramento, CA	122%
Seattle, WA	72%
St. Louis, MO	43%
Washington, DC	128%
National Average	**59%**

SOURCE: Federal Housing Finance Agency (FHFA) Home Price Index

Figure **2** **Mortgage Debt in Private Pools**

Year	Debt ($ trillions)
2007	$3.0
2006	$2.8
2005	$2.1
2004	$1.5
2003	$0.6
2002	$0.5
2001	$0.4
2000	$0.4

SOURCE: Federal Reserve

But the rise in home prices that began in the late 1990s and crested in 2006 was quite different. Though stronger in some places than others, it included most major markets in the United States. Between 2000 and 2006, 66 percent of American homeowners saw the value of their home increase by at least one-third and 35 percent saw that value more than double (see Figure 1).

Not everyone participated in the price boom, because some local markets always face economic difficulties. Many smaller markets, in particular, lost jobs and population during that period.

This unusual economic phenomenon—a general rise in home prices without a sharp increase in inflation—flowed from a number of factors, including policy decisions by the Federal Reserve to encourage low interest rates, low inflation due to cheap imports from China, efforts by the government to expand homeownership and demand from investors for securities with higher returns.

Low inflation allowed the Fed to keep interest rates low. Low interest rates made mortgages affordable to a larger segment of the population. Low interest rates increased demand for investments with higher returns.

Demand from Wall Street expands mortgage lending

The desire for higher investment returns, initially from institutional investors such as pension funds that have long-term obligations, brought a new source of funding to the housing industry and skewed the economics of mortgage lending.

Subprime mortgages had until somewhat recently been a high-risk specialty product, but Wall Street magically turned them into a seemingly low-risk security with high returns, and investor demand exploded. Not only pension funds, but banks and hedge funds—and the Wall Street firms themselves—found the returns on these securities irresistible.

Any pool of mortgages can be structured into tranches, some of which have high yields. But pools of mortgages with many high-risk loans provide a much larger volume of the high-yield tranches. Demand from Wall Street for high-risk mortgages brought many new buyers into the home market, and coincidentally lowered underwriting standards for all mortgages.

The outstanding amount of Wall Street-sponsored mortgage pools jumped from $400 billion in 2000 to $3 trillion in 2007, according to the Federal Reserve (see Figure 2).

Whether due to government policies or Wall Street demand for riskier mortgages, the number of people able to buy a home expanded rapidly in the last decade. According to the U.S. Census Bureau, the national homeownership rate increased from 64 percent in the mid-1990s to 69 percent in 2006—about 6 million extra homes (and mortgages).

Homeowners speculate in real estate

The new demand for homes since 2000 reinforced local housing shortages that naturally arise in a mobile society when the economy is expanding, and pushed up home prices in many local markets. At the same time, many individuals who had witnessed the dot-com stock market crash in 2001 pulled their money out of stocks and, with interest rates low, looked for alternative investments.

Real estate seemed like a good buy. With the high leverage supplied by a mortgage with a low interest rate, investors needed only a small increase in home prices to get a huge return, and prices had risen steadily for years.

While few Americans consider themselves speculators, many were willing to invest in real estate in the guise of buying a vacation home, an eventual retirement home or a time-share condo. In many vacation markets, almost half of all home purchases in recent years were due to such soft speculation (see Figure 3).

Your house as a cash machine

With the forces of government policy, Wall Street demand, an expanding economy and genteel real estate speculation all aligned on one side of the equation, it's not surprising that home prices rose year after year in all but the most economically depressed areas.

The result was that the majority Americans saw a large increase in the apparent value of their home. Although only the very small percent that actually sold their home were able to achieve that gain, everyone else *thought* the value of their home had increased by a similar amount. And so did their bankers.

And they now had a simple way to tap that value without moving to a cheaper market, as the California defense workers had been forced to do: They got a home-equity loan or refinanced their home with a larger mortgage and took out the difference in cash.

According to the Federal Reserve, mortgage debt on single-family homes increased from $5 trillion in 2000 to about $11 trillion in 2007 (see Figure 4), and about $3 billion of this increase was due to home-equity loans and cash-out refinancings.

Fragility of home pricing

Like prices for many commodities and financial investments, current prices for homes are set by the most recent buyers and sellers—of whom there are surprisingly few. In a typical year, only about 5 percent of the homes in a market are sold, which means that at any one time only about 1 percent of homes are actually on the market. Whether those homes are sold for a higher or lower price determines the value of the other 99 percent.

Relatively small changes in the local economic situation also can have an outsized effect on home prices. In a typical housing market with average population growth of 1 percent per year, home builders can match the demand for new homes fairly easily. But when an influx of new jobs pushes annual population growth up to just 2 percent, demand exceeds the ability of home builders to increase the supply quickly enough and home prices rise rapidly.

A brief price history of the bust

Homeowners took money out of their homes and bankers of all stripes let them do it, because of the hope on all sides that home prices would continue to go up (but in any case would not go down). The fragility of home pricing works both ways, however, so it didn't require much of a slowing of demand for prices to stop their quick rise and begin a long descent.

The fact that real estate markets are local is emphasized by the very scattered way in which the home-price boom came to an end. First to peak were markets that had not seen much of an increase in home prices since 2000, mainly because of fundamental problems with the local economy. Ann Arbor, Michigan, was the first market to peak, in the second quarter of 2005, followed in the next quarter by Detroit, Cleveland and other markets in Michigan and Ohio.

The fourth quarter of 2005 was the peak for three of the California markets that had seen the biggest boom—Santa Barbara, Sacramento and Salinas, where home prices had more than doubled.

The first quarter of 2006 was the peak for more California markets, including Modesto, San Diego and Santa Rosa. It was also the peak for the first Florida boom markets—Melbourne and Vero Beach. And it was the end of the boom for Reno and Carson City, Nevada.

The second and third quarters of 2006 were the peak for large numbers of markets in Florida and California, including Fort Myers, Bradenton, Naples, Fort Lauderdale and West Palm Beach in Florida; and Anaheim, San Jose, San

Figure **3** **Percentage of Home Purchases Made by Investors (2005)**

City	Percent
Myrtle Beach, SC	64%
Panama City, FL	47%
Naples, FL	46%
Wilmington, NC	41%
Cape Coral–Fort Myers, FL	41%
Sarasota-Bradenton, FL	40%
Vero Beach, FL	40%
Orlando, FL	29%
Boise, ID	28%
Las Vegas, NV	27%
Atlantic City, NJ	27%
Charleston, SC	26%
Phoenix, AZ	26%
Honolulu, HI	25%
Albuquerque, NM	22%
Austin, TX	20%

SOURCES: HOME MORTGAGE DISCLOSURE ACT (HMDA) DATA, FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL (FFIEC)

Figure **4** **Single-Family Mortgage Debt**

Year	Debt ($ trillions)
2007	$11.1
2006	$10.4
2005	$9.4
2004	$8.2
2003	$7.2
2002	$6.4
2001	$5.6
2000	$5.1

SOURCE: FEDERAL RESERVE

Francisco and Riverside–San Bernardino in California.

The fourth quarter of 2006 saw the end of the boom for Los Angeles and Tampa–St. Petersburg, Florida; and the spread of the end to other parts of the country, such as Las Vegas, Phoenix and Washington, D.C.

It wasn't until the first quarter of 2007 that the end hit in Chicago, the New York City area and other parts of the Northeast; not until the second quarter that Miami, the last big boom market, hit its peak; not until the fourth quarter of 2007 that Seattle, Portland and other parts of the Northwest were affected; and not until the first quarter of 2008 that the recession brought about a general end to price increases in the rest of the country.

Short-term problems for mortgage bankers

Mortgage bankers face two problems in the near term—finding new business and determining the risk of new business. Both problems are related to home prices, because demand for mortgages is weak in markets where home prices are still falling—that's why they're still falling—and because the risk that homeowners will default on their mortgage increases if home prices fall after a mortgage is written.

The Local Market Monitor forecasts home prices in 315 markets and currently doesn't see a national trend toward price recovery. Prices are rising modestly in some markets, but will continue to fall in others. Generally, the markets that had the greatest boom in prices have also had the greatest bust, and in a number of these markets prices will continue to fall for several years (see Figures 5 and 6).

Even after prices stabilize, however, demand in many markets will never be close to its former volume, because the former volume was driven by second-home buying and speculation that have been wiped out for the next decade. Many smaller markets in California and, especially, in Florida, fall into this category of disappearing volume. But even large markets such as Las Vegas and Phoenix are not immune from the problem.

Although home prices have fallen substantially in many markets, the risk that prices will fall another 20 percent or more is fairly high in some places. How much further prices will fall varies from market to market, and depends on how high prices still are above a sustainable level we call the Equilibrium Home Price.

In some markets, such as Los Angeles and Modesto, California, home prices exceeded the Equilibrium Home Price by more than 100 percent at the height of the boom. So, even though prices have already dropped 25 percent in Los Angeles and 48 percent in Modesto, further price declines are almost certain. On the other hand, prices in markets such as Minneapolis and Denver are now close to the Equilibrium Home Price, so we don't expect much more of a decline (see Figure 7).

A market growth strategy for mortgage bankers

For the next decade, until memories of the bust finally fade, consumers will get back to basics about homes and mortgages—and mortgage bankers should do the same. Rather than finding mortgage business just about everywhere, they will mainly find business in markets with growing populations and growing economies. They will find the least risk in markets where home prices will increase at a moderate level. And they will be able to assess market risk by monitoring how far home prices are above the Equilibrium Home Price.

Population growth is difficult to measure and can change rapidly, but a fair approximation is given by job growth. Right now the job situation is grim throughout

Figure **5** **Home-Price Changes to Maximum Value (2000–2009)**

Metro Area	Boom	Bust
Miami, FL	160%	-30%
Madera, CA	153%	-30%
Bakersfield, CA	151%	-35%
Riverside–San Bernardino, CA	150%	-39%
Fresno, CA	148%	-32%
Naples, FL	147%	-39%
Los Angeles, CA	146%	-25%
Fort Lauderdale, FL	146%	-33%
West Palm Beach, FL	141%	-32%
Port St. Lucie, FL	139%	-40%
Cape Coral–Fort Myers, FL	137%	-41%
Yuba City, CA	137%	-39%
Merced, CA	134%	-56%
Palm Bay–Melbourne, FL	131%	-31%
Modesto, CA	131%	-48%
Santa Ana–Anaheim, CA	130%	-26%

SOURCE: FHFA Home Price Index

Figure **6** **Home-Price Forecast (Q3 2009–Q3 2010)**

City	Percent
Atlanta, GA	-6%
Baltimore, MD	-7%
Boston, MA	-3%
Charlotte, NC	-4%
Chicago, IL	-7%
Denver, CO	-2%
Detroit, MI	-9%
Houston, TX	0%
Las Vegas, NV	-16%
Los Angeles, CA	-4%
Miami, FL	-16%
Minneapolis, MN	-4%
New York, NY	-5%
Philadelphia, PA	-4%
Phoenix, AZ	-17%
Sacramento, CA	-7%
Seattle, WA	-9%
St. Louis, MO	-2%
Washington, DC	-1%
National Average	**-5%**

SOURCE: Local Market Monitor

much of the country, and some markets such as Las Vegas will not jump back to high levels of growth when the recession is over.

As always, there will be winners and losers, with some markets faring better or worse as the economy redistributes job opportunities. Markets in Michigan and Ohio linked to the auto industry, for example, will probably have job losses and population stagnation for some years to come, while auto-related markets in the South will grow.

Markets that will have the most difficulty emerging from the recession are likely to be those that formerly had high growth but have lost large numbers of jobs, often in construction. This unfavorable swing has been greatest in markets such as Prescott, Arizona; Boise, Idaho; Phoenix; Cape Coral–Fort Myers and Naples, Florida; Las Vegas; and Charlotte, North Carolina (see Figure 8).

On the other hand, markets likely to recover best and experience good population growth are those that had moderate growth before the recession and saw only a moderate drop in jobs. These include the Austin, Fort Worth, San Antonio and Dallas markets in Texas; but also Little Rock, Arkansas; Tallahassee, Florida; and Chattanooga, Tennessee (see Figure 9).

For the next few years, home prices will provide the best indication of where mortgage business will be growing best. In markets with renewed job growth, new jobs will initially go to workers who already live there and don't need new homes. But the behavior of home prices will signal where demand for new housing—and therefore new mortgages—is strongest.

We're still in a holding pattern, waiting for clear evidence that individual markets have bottomed out. By next year, I expect to see stronger prices in dozens of markets.

In both the short and longer term, as distortions of supply and demand get worked out and then reappear in some markets, the level of home prices compared with the Equilibrium Home Price will give the best indication of the risk that prices will fall again in some future boom and bust.

Above all, in this very difficult period as the recession and its aftermath reshape local economies, mortgage bankers must stick to the basics to find those markets where future demand will be strongest. **MB**

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Figure **7** **Excess of Current Home Price Over Equilibrium Price**

Metro Area	Percent
Atlanta, GA	19%
Baltimore, MD	27%
Boston, MA	27%
Charlotte, NC	10%
Chicago, IL	6%
Denver, CO	11%
Detroit, MI	6%
Houston, TX	-1%
Las Vegas, NV	-18%
Los Angeles, CA	39%
Miami, FL	28%
Minneapolis, MN	15%
New York, NY	32%
Philadelphia, PA	18%
Phoenix, AZ	14%
Sacramento, CA	13%
Seattle, WA	11%
St. Louis, MO	9%
Washington, DC	29%

SOURCE: Local Market Monitor

Figure **8** **Growth Markets Unlikely to Recover Quickly (Job Growth in Prior 12 Months)**

Market	July 2006	July 2009	Change
Prescott, AZ	7.3%	-8.9%	-16%
Boise, ID	7.0%	-7.4%	-14%
Phoenix, AZ	5.2%	-7.8%	-13%
Cape Coral–Fort Myers, FL	4.6%	-7.8%	-12%
Las Vegas, NV	5.2%	-6.6%	-12%
Naples, FL	5.1%	-6.4%	-11%
Provo, UT	6.2%	-4.8%	-11%
Charlotte, NC	4.5%	-6.2%	-11%
Portland, OR	3.3%	-5.8%	-9%
Orlando, FL	3.4%	-5.6%	-9%
Raleigh, NC	5.1%	-3.7%	-9%
Salt Lake City, UT	4.4%	-4.2%	-9%

SOURCE: Bureau of Labor Statistics

Figure **9** **Markets with Good Growth Prospects (Job Growth in Prior 12 Months)**

Market	July 2006	July 2009	Change
Lafayette, IN	2.2%	0.8%	-1%
Des Moines, IA	2.3%	-0.9%	-3%
Fayetteville, AR	2.8%	-0.5%	-3%
Little Rock, AR	2.3%	-1.6%	-4%
Austin, TX	3.7%	-0.2%	-4%
Fort Worth, TX	2.9%	-1.4%	-4%
San Antonio, TX	3.7%	-0.8%	-5%
Dallas, TX	3.0%	-1.6%	-5%
Tallahassee, FL	2.4%	-2.7%	-5%
Richmond, VA	2.0%	-3.4%	-5%
Chattanooga, TN	2.3%	-3.1%	-5%
Tacoma, WA	2.9%	-2.7%	-6%

SOURCE: Bureau of Labor Statistics