STATE OF THE INDUSTRY

By Ingo Winzer
ever in the modern era of banking has there been such a loss of real estate value. Never have so many mortgages been delinquent or foreclosed, or so many homeowners underwater.

The last few years have been trying times for everyone involved in the housing markets—homeowners, lenders, builders, brokers, servicers—but the worst is now over; so it’s time to set our sights on recovery and examine how changes in the consumption of real estate have altered—and will continue to alter—the state of the industry. One thing we can be sure of—whether through new regulations, changed practices, or evolving economic fundamentals—housing markets will never be the same.

**Boom and Bust Lessons**

As the title character of the long-running satirical comic strip Pogo said, “We have met the enemy and he is us.” A big reason for the big real estate bust is there was such a big boom, a boom with bad consequences not just for housing but for the U.S. economy as a whole.

If home prices had just gone up and then down again as happens every once in a while, the damage would have been limited to those homeowners unlucky enough to buy at the top of the market. But as home prices rose year after year, everybody wanted to get in on the act. Builders built more; bankers lent more; and, most fatefully, homeowners cashed in the extra equity in their homes to buy cars and TVs and furniture, extending the economic expansion but leaving them tapped out when the party was over.

Unintended consequences also followed from benign government policies. The invention of the toxic mortgage security flowed directly from ever lower interest rates, normally a good thing but a problem for pension funds and insurance companies with fixed future commitments. Hedge funds also need high returns to attract investors; and banks can’t survive on spreads when interest rates are low.

All found a solution to their problem in the higher-yielding securities fashioned by Wall Street wizards who claimed the experience of low losses in the small subprime market could extend to an enormously larger volume of business. Homeownership policies encouraged “creative” lending to aspiring homeowners and the homeownership rate, around 65 percent for decades, rose to 69 percent.

None of this was meant to end badly. Yes, there were excesses—executives thinking mainly of year-end bonuses, regulators unable to regulate their politically connected charges, unethical speculators flipping properties, and small banks gambling on crony real estate

As we pull out of the depths of the crisis, it’s time to face the inevitable changes and bring to light the new ‘normal’ for housing in America.
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developments. But the confounding reality of the boom is that it was driven by perfectly ordinary economic and political behavior.

We can try to prevent this boom and bust from happening again. We will write tighter standards for mortgage products, demand better analysis from rating agencies, and hold executives more accountable. But we can’t prevent some other boom and bust from happening, not unless the mortgage and housing industries are nationalized. The separation between today’s value and tomorrow’s risk at the heart of the real estate market cannot be regulated away. The biggest lesson to learn from the recent debacle is this cycle will happen again although it will look different.

Market Shifts

The U.S. population is not a single mass but many smaller demographic pieces, and we happen to be in a period where some of those pieces are changing very rapidly with big consequences for real estate markets.

Baby Boomers

I’m one of them myself, the group of people born between 1946 and 1964. There are about 80 million baby boomers, and they drove the real estate market during the past 20 years because of their large numbers and high incomes. The youngest of them are now close to 50, the oldest over 65. They bought suburban homes with enough bedrooms to raise 2.5 children, but now the children are grown and no longer live with them (if they’re lucky). Even after the fall in home prices, they have equity in their homes. Cashing in and downsizing makes a lot of sense.

Over the next five years, 19 million baby boomers will cross the 60-year mark, and 16 million will cross the 65-year mark. Eighty percent are homeowners, and many will put their houses on the market, making the upper end of the market one that favors buyers.

Many will move from the suburbs to the city. Growth in many central cities is now stronger than the growth in their suburbs; prominent examples include Austin, Denver, Raleigh, and Tampa, but it’s also the case in Omaha, Memphis, and Kansas City. Baby boomers aren’t the only reason for this trend. The rejuvenation of central cities and their cultural life is a magnet for empty-nesters—a dynamic to note for builders and brokers.

The Hispanic Population

In the last decade, the U.S. population increased by 27 million people to just over 300 million. Of that number, 15 million described themselves as Hispanic or Latino and only 2 million as white—not Hispanic or Latino. Leaving behind the tortured wording of the Census Bureau, the Hispanic population grew quickly to 50 million while the white population, at 200 million, almost stalled.

Right now the average Hispanic family is larger than the average white family, has three-quarters the income, and is as likely to rent as to own a home. The Hispanic homeownership rate is 50 percent, while the homeownership rate for whites is 70 percent.

Although Hispanics are still heavily concentrated in the Southwest and West, they are an important presence across the country. While California, Florida, New York, and Texas have long had large Hispanic populations, in 18 states Hispanics are more than 10 percent of the population, including such newcomers as Washington, Illinois, Kansas, and Connecticut. Builders, lenders, brokers, and servicers must adapt to this rising economic force.

Slower Income Growth

In 1980, the average house cost four times the average family income. The same was true in 1990 and 2000. Right now, in 2012, the multiple is a touch higher at 4.2. Clearly, and as you would expect, how much people will pay for a house depends closely on how much money they make.

But the income prospects for Americans changed as the American economy moved away from well-paid manufacturing jobs to lower-paid service and health-care jobs. To a very large degree, computers and computerized machines replaced middle-managers and skilled workers. Yes, new jobs were created to control the computers but far fewer of them.

Adjusted for inflation, wages and salaries in the U.S. rose 20 percent in the 1980s and 30 percent in the 1990s, but only 4 percent from 2000 to 2005 and not at all from 2005 to 2010. Homebuyers in this next decade cannot afford the homes of the last decade.

The Next Few Years

The overall picture is promising. Local Market Monitor’s Housing Demand Index, negative since mid-2006, is almost back to zero. (See Figure 1) The index is based on hiring by homebuilders, mainly small operators who are closest to local market conditions. Real estate cycles in some ways follow a predictable course: there aren’t enough homes, so prices go up; higher prices spur both sellers and builders until there are too many homes, so prices go down. The last cycle was different because much of the demand that drove prices higher came from efforts to generate more subprime mortgages, essentially creating new homebuyers who couldn’t really afford to buy a home. The fallout was not just lower prices but large numbers of delinquencies, foreclosures, and unhappy people.

The supply and demand part of this sorry situation is almost worked out. The U.S. population grows by about 1 percent per year, or 3 million people. With an average 2.5 people per household and including a small amount for replacement of old units, that’s 1.25 million new housing units needed every year.

From 2002 through 2007, 11 million new homes were built, about 4 million too many. In the following four years, just 2 million homes were built, about 3 million too few. So, this
year we’re pretty much using up the remaining excess, and that’s why home prices are now bottoming out.

They’re not just bottoming out. In many markets, home prices are now below the local income-equivalent price, sometimes by more than 20 percent. As the economy picks up, since homebuilders will be unable to catch up with demand fast enough, home prices in these markets will rise at 5 or 6 percent a year, just to get back to even.

Home prices in many markets are now below the local rent-equivalent price. When home prices rise, rents don’t rise as much, and investing in rental properties becomes uneconomic. When prices fall, rents don’t fall as much; in fact, they almost never fall, and at some point rental properties are again an attractive option. That’s the case now in many local markets; investors can again buy vacant homes and rent them out, a good thing because foreclosed homeowners must live somewhere. Where home prices are also below the income-equivalent price, investors get the added bonus of a strong rebound in the value of their investments over the next five years or so.

Getting Specific

Aside from the overall picture, what the future holds depends very much on individual local markets. Of the 315 markets Local Market Monitor tracks, about half had no real estate boom at all and therefore, no bust. Many of these largely unscathed markets are in the Midwest, but Denver, Dallas, and Atlanta also skirted the worst of the downturn. In general, these markets now have lower unemployment and higher job growth and will soon be back to “normal.”

Of the markets that did have a sharp boom and subsequently a debilitating bust—many in Florida, California, Arizona, and Nevada, but also Washington, D.C., Seattle, and New York—there are now two types: those set to recover and those with longer-term economic problems. Those positioned for recovery have low unemployment and strong job growth; Salt Lake City is a good example. The others have continuing problems with high unemployment and slow job growth, a prime example being Las Vegas.

Florida

Some markets will still hurt for a while, mainly those where homes were built for second-home buyers. This includes most markets in Florida. There just isn’t enough local demand, especially since 400,000 construction jobs disappeared. The second-home market is dead for now, so prices in many of these markets will drop further still and then languish. The problem is worst in the smaller coastal markets because the retirees who will eventually absorb the inventory prefer proximity to the big cities.

California

Many markets in California also had too much construction, especially those to the east of the Bay Area, where land was cheaper. But unlike Florida, job growth has picked up and immigration will resume. Big cuts in government jobs have dampened housing demand in many smaller markets, and of course in Sacramento, but prices in most markets will bottom out in the next year.

Texas

With a few exceptions (Midland, Odessa, El Paso), Texas markets didn’t have a boom this time around and didn’t have a bust. A quick recovery from the recession abetted by the energy industry encouraged migration from other states. Home prices generally have been flat the last few years and are now well below the levels local incomes can support, setting up a good future as the overall economy grows.

Other states recovering well from the recession include North Carolina, Utah, and Tennessee.

It’s the Economy, Stupid!

As far as real estate is concerned, we don’t have a national economy; we have hundreds of local ones. That said, how quickly real estate recovers depends very much on economic growth. At Local Market Monitor, our current home price forecasts assume the economy will grow slowly for another year but improve rapidly thereafter, leading to annual price increases of 3 to 6 percent in most markets. A sideways economy would put our forecasts at the lower end of that range.

Real estate and economic cycles are usually out of sync; real estate cycles are longer because it takes longer to iron out housing supply and demand differences. This time the cycles are very closely linked because the boom in home prices had a lot to do with the recession that followed. We’ve reached a point now where real estate will recover even if the economy remains sluggish because the excess construction of previous years is almost absorbed. But the speed and extent of the recovery in real estate depends on local job creation, which can’t thrive unless the national economy grows.

Food for Thought

Demographic changes in the housing market have several implications, the chief one being that future homebuyers will have lower income. The lower end of the market will be the most active. Builders must build less expensive homes, and lenders must produce more affordable mortgages without increasing default risk.

Does this mean 40-year mortgages, rent-to-buy, and communal guarantors? It can’t just mean higher loan-to-value ratios, government guarantees, and lower income qualifications or we’ll find ourselves back in the subprime soup.

Ingo Winzer is president of Local Market Monitor and has analyzed real estate markets for more than 25 years. In 2005, he warned that many housing markets were dangerously overpriced; two years later, his assessment manifested in the biggest housing bust of a generation.