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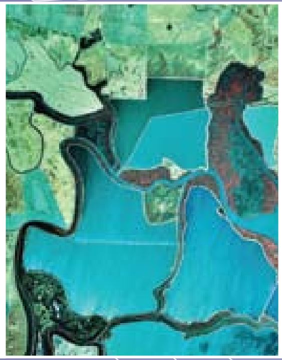


Executive Summary

After setting records for home sales, single-family starts, and house price appreciation in 2005, housing markets abruptly reversed last year. In 2006, total home sales fell 10 percent, starts tumbled 13 percent, and nominal house price appreciation slowed to just a few percentage points. Suddenly, it was inventories of unsold vacant homes that set records and homes in foreclosure that were making the news.

The length and depth of the current correction will depend on the course of employment growth and interest rates, as well as the speed with which builders pare down excess supply. But the longer-term outlook for housing is more upbeat. Thanks in large part to recent immigrants and their native-born children, household growth between 2005 and 2015 should exceed the strong 12.6 million net increase in 1995–2005 by some 2.0 million. Together with the enormous increase in household wealth over the past 20 years, healthy income growth will help propel residential spending to new heights.

But housing affordability remains a pervasive problem. In just one year, the number of households with housing cost burdens in excess of 30 percent of income climbed by 2.3 million, hitting a record 37.3 million in 2005. Making real headway against this disturbing trend requires an unlikely combination of structural and public policy shifts—that state and local governments ease development regulations that drive up production costs, the federal government adds meaningfully to already significant expenditures aimed at relieving heavy housing cost burdens, and economic growth dramatically lifts the real incomes and wealth of the bottom quarter of households.

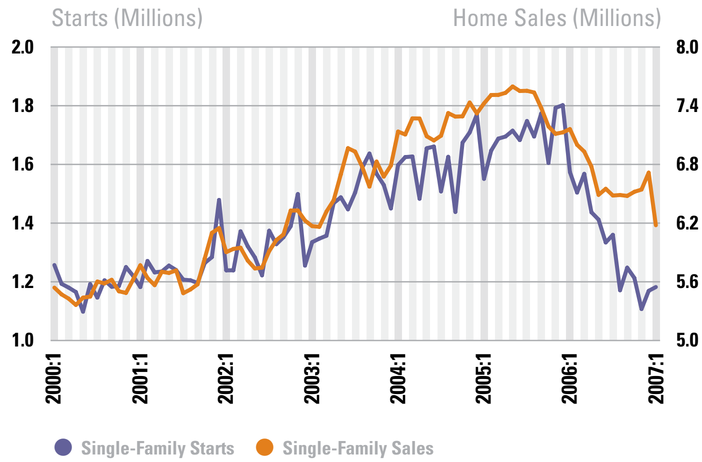
THE CORRECTION TAKES HOLD

Although single-family starts and sales both peaked in 2005, it was not until early 2006 that year-over-year declines began to accelerate **(Figure 1).** From there, conditions eroded quickly as the air went out of the inflated demand in the for-sale market.

When housing was at its hottest, demand had been pulled forward first by falling interest rates and then by unprecedented house price appreciation. Homebuyers snapped up the limited supply of homes to get in on the rising prices and avoid having to pay more later. Investors also entered the market, intending to resell quickly. Home builders attempted to meet the surge in demand, but the long lag

FIGURE 1 **Despite the Drop in Starts and Sales...**

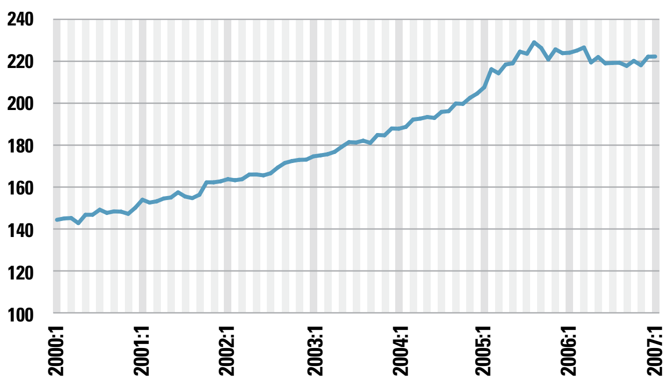
Seasonally Adjusted Annual Rate



Note: Sales include new and existing homes.
Source: US Census Bureau and the National Association of Realtors®.

...House Prices Have Yet to Fully Correct

Median House Price (Thousands of dollars)



Notes: Data are seasonally adjusted. Median house prices are nominal prices of existing single-family homes.
Source: National Association of Realtors®.

between predevelopment work and housing completions led to bidding wars that drove prices up further. Meanwhile, mortgage lenders looking to increase market share supplied loans to borrowers with tarnished credit records and offered "affordability" products with lower initial payments to buyers anxious to get into the market. With this increase in credit availability, prices kept climbing.

The turning point came in late 2005 when the combined impact of rising mortgage interest rates and higher house prices finally forced out some buyers. Making matters worse, a growing number of foreclosed homes were returning to the market. With home sales softening and house price appreciation slowing, the urgency to buy evaporated and investors began their exit. Although builders pulled back hard on production, the retrenchment came too late.

The correction intensified in the second half of 2006 and spread to numerous metropolitan markets. On a year-over-year basis, 277 metros registered declines in housing permits in the fourth quarter, up from 178 in the first. At the same time, 74 of the 148 metros evaluated by the National Association of Realtors® posted a fourth-quarter over fourth-quarter drop in nominal median home prices.

THE INVENTORY OVERHANG

Now that the downturn is in full swing, the question of its depth and duration hangs over the market. Much depends on what happens with the economy, interest rates, and credit availability. But it also depends importantly on just how much demand was inflated during the housing market run-up and how fast builders can work off the oversupply of homes.

The clearest indicator of how much excess inventory exists is the 500,000-plus jump in vacant homes for sale between the end of 2005 and the end of 2006. This figure may, however, understate the full overhang because some units classified as vacant, such as some seasonal or occasional use homes, may be brought back onto the market when conditions improve.

But assuming the half-million figure is a reasonable estimate, demand for new homes was about 250,000 units below the 2.1–2.2 million added in both 2004 and 2005. This suggests that sustainable annual demand was about 1.9 million homes over this period. Since housing starts and manufactured home placements were still at about that level last year, there was no progress toward cutting excess inventories. Starts and placements combined would thus have to fall to 1.65 million for at least two years to work off such an oversupply. If the excess is closer to 800,000 units, placements and starts would have to hold near 1.5 million per year. In the most pessimistic view, the overhang may exceed 1.0 million units, meaning some rental vacancies may need to be worked off as well.

In reality, of course, things do not work out this neatly. Builders may overshoot the mark on the downside or pull back too slowly. Demand may strengthen if interest rates decline or job growth picks up, but it could also soften further if credit is constrained or the economy falters. On a local level, some markets will correct more quickly than others based on builder behavior and general economic conditions.

SOFTENING HOUSE PRICES

With the national nominal median house price still up for the year, housing wealth effects—the tendency of owners to spend more when home prices are rising, and to borrow more against their equity to support that spending—remained a plus for the economy in 2006. Indeed, the amount of home equity cashed out set a record even though the volume of refinances dropped off sharply. The potential impact of the housing slowdown on consumer and remodeling spending has therefore yet to hit.

Home prices are likely to soften further. Home sales and starts usually head down before prices. Declining sales, and the inventory overhang left in their wake, increase the length of time homes are on the market as well as buyers' resistance to higher prices. Eventually motivated sellers—like home builders and investors with unoccupied homes for sale—reduce their prices. This process takes time and only began late in 2006 and only in some places.

Overbuilding, job losses, and rapid appreciation can all contribute to house price declines. Of these, major employment cuts and large excess supplies are the far greater threats. Indeed, rapid price appreciation by itself seldom leads to corrections. In the 75 largest metropolitan areas, there were 30 instances of severe overheating (at least 15-percent nominal price appreciation per year for three consecutive years) between 1980 and 2000. In the 12 cases where overheating alone occurred, only four metros saw a nominal price decline and only one saw a drop of more than five percent. In the other 18 instances where overbuilding and/or net employment loss accompanied the overheating, some 13 metros experienced nominal price declines and 12 saw a drop of more than five percent.

MORTGAGE LOAN RISKS

Subprime lending took off after 2003, just about the same time that house price appreciation accelerated. Indeed, if borrowers with these higher-priced loans got into trouble, their rapidly rising home values enabled most to sell at a profit or refinance to avoid default.

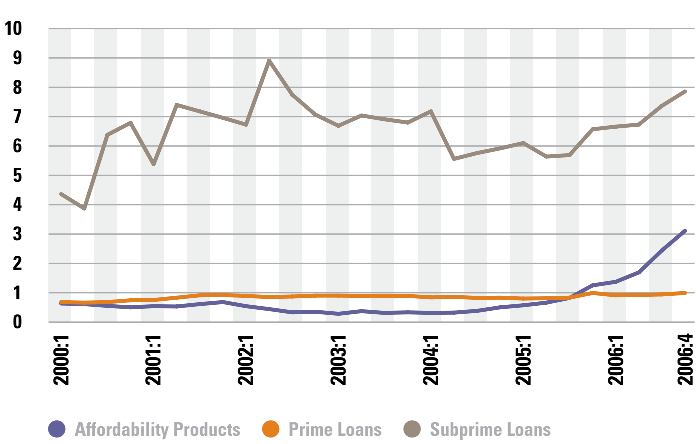
Like subprime loans, mortgages with interest-only and payment-option features—sometimes called "affordability products"—have gone from relative obscurity to large shares of the market. Available at both prime and subprime rates, interest-only loans allow borrowers to defer principal payments for a set period, while payment-option loans allow borrowers to defer even a portion of the interest payment. First American LoanPerformance reports that these products went from less than five percent of all mortgage originations in early 2002 to 38 percent in mid-2005, before falling back to 32 percent at the end of 2006.

Adjustable-rate mortgages also gained market share in 2003–2005. Despite offering only a small interest-rate advantage over fixed loans, adjustable mortgages were up sharply thanks to steep initial discounts. Large shares of subprime and Alt-A loans originated since 2004 have adjustable rates that are scheduled to reset between two and five years after origination, resulting in potentially significant increases in monthly payments. According to Credit Suisse, the amount of adjustable-rate subprime debt expected to reset in 2007 and 2008 alone could be as much as $482 billion. Alt-A loans account for another $57 billion scheduled to reset by 2008, and $85 billion in 2009 and 2010. Much of this debt is, however, likely to be either refinanced or paid off at the time of sale before the reset dates hit.

In the absence of rapid house price appreciation, the risks imposed by subprime adjustable-rate products are much greater. As the first wave of these loans begins to reach their reset dates, the signs are not encouraging. Between the fourth quarter of 2005 and the fourth quarter of 2006, the share of troubled subprime loans jumped from 6.6 percent to 7.9 percent **(Figure 2).** As increasing numbers of borrowers risk losing their homes to foreclosure, higher than expected losses have driven some mortgage companies into bankruptcy and others to increase their reserves against losses.

FIGURE 2 **Delinquency Rates on Subprime Loans and Affordability Products Rose Sharply Last Year**

Troubled Loan Share (Seasonally adjusted)



Notes: Troubled affordability products are loans with interest-only or payment-option features that are at least 60 days past due or in foreclosure as of the end of the quarter. Troubled prime and subprime loans are conventional and conforming loans that are at least 60 days past due or started foreclosure proceedings in the quarter.
Sources: First American LoanPerformance and Mortgage Bankers Association, National Delinquency Survey.

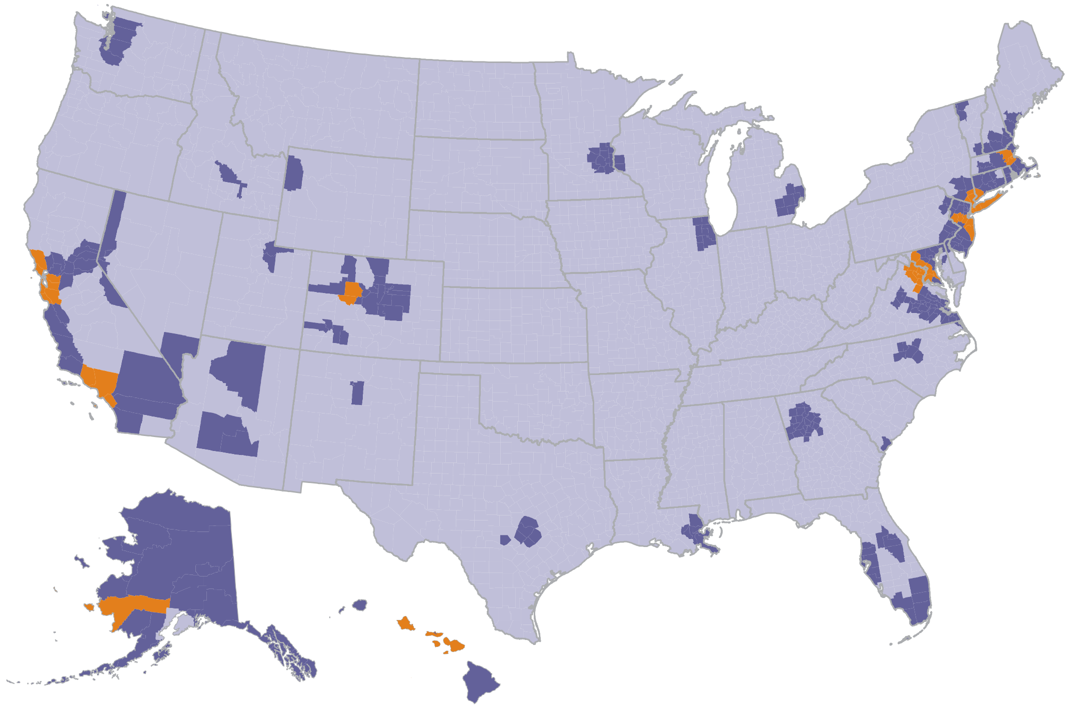
UNRELENTING HOUSING CHALLENGES

Weak income growth among households in the bottom half of the distribution, together with restrictive land use regulations, has led to the implacable spread of affordability problems. Local restrictions on development discourage production of lower-cost housing, forcing up both rents and prices. Even with the addition of roughly 78,000 new and 55,000 renovated units through the federal tax credit program in 2005, the supply of affordable rentals continues to shrink.

The result is that the pressures of high housing costs are moving up the income scale. Even after the minimum-wage increase is fully implemented, households with a single minimum-wage worker will still be unable to afford even a modest two-bedroom rental apartment at today's rents anywhere in the country **(Figure 3).** Meanwhile, severely cost-burdened households in the bottom expenditure quartile had just $436 a month left to cover all other needs in 2005. To escape these heavy cost burdens, more and more households are resorting to long commutes or doubling up with other family members.

Federal assistance to very low-income households reaches only about one-quarter of eligible renters and virtually no homeowners. Still, only a handful of state and local governments have had the political will to overcome some of the barriers to development of affordable housing. With little regulatory relief in sight and slim chances for a significant expansion of federal subsidies, the prospects for a meaningful reduction in the number of housing cost-burdened households are dismal.

FIGURE 3 **Even Fully Phased In, the New Federal Minimum Wage Would Not Cover Today's Rent on a Modest Apartment**



Notes: Housing wage is the hourly wage required to afford a modest two-bedroom apartment renting for the Fair Market Rent, paying 30% of pre-tax income for housing and working 40 hours a week for 52 weeks. Income ranges are multiples of the federal minimum wage at full rollout, expected in 2009. Analysis based on methodology developed by Cushing N. Dolbeare and the National Low Income Housing Coalition.
Source: US Department of Housing and Urban Development, Fiscal Year 2006 Fair Market Rents.

THE HOUSING OUTLOOK

It is too early to determine when the housing slump will end. House prices are only beginning to soften, loans most at risk are just starting to hit their reset dates, and credit standards have tightened. The adjustment will be particularly painful for those homeowners overwhelmed by higher mortgage payments, lenders that underestimated risk, and builders and owners forced to sell at lower prices.

Yet however long the correction lasts, housing markets will eventually recover. Once excess inventories and credit problems are worked out and balance is restored, ongoing demand for new and improved homes promises to lift the value of new construction and remodeling to new highs. Greater productivity will help raise real incomes for many, while record wealth will allow households to spend more on housing. But between strong growth in demand and increasingly restrictive development regulations, house prices will continue to move up.

The number of new homes demanded will also increase, thanks to immigration trends and the aging of the baby-boom and echo-boom generations. Over the next 10 years, the baby boomers will pass through the age range when second-home ownership peaks, while the echo boomers will move into the prime household-forming years. After contributing more than a third of net household growth between 1995 and 2005, new immigrants will likely account for at least that large a share between 2005 and 2015. The children of immigrants born in the United States will also add significantly to household growth.

Overall immigration is on course to hit a record-setting 12 million between 2005 and 2015. Ongoing inflows have lifted household growth, increased the racial and ethnic diversity of America's households, and driven the revitalization of many inner cities. As a result, the foreign born are increasingly vital to the housing market, representing some 14 percent of recent homebuyers and 18 percent of renters in 2005. While still concentrated in a handful of gateway metros, immigrant households are beginning to settle in a growing number of locations across the country.

With household growth accelerating, demand for second homes rising, and the housing stock aging, new home demand should total about 19.5 million units from 2005 to 2014. Although the pressures on lenders to tighten underwriting standards and on builders to work off a still-unknown surplus could reduce the total somewhat, new home completions plus manufactured home placements should easily surpass the 18.1 million added in 1995–2004.