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Housing Markets

With the sudden departure of investors and homebuyers priced out of the market, housing activity slowed dramatically in 2006. Indeed, only rental markets and remodeling activity were still expanding last year. The recovery in the for-sale market faces the triple threat of tighter lending standards in the wake of high subprime default rates, a still significant overhang of vacant homes for sale, and buyers waiting on the sidelines to see if prices drift lower.

FROM BOOM TO BUST

Last year snapped a string of record-setting years for home sales and price appreciation (**Figure 4**). Sparked by 40-year lows in interest rates, demand took off in 2001. As markets tightened and house price appreciation began to accelerate, investors piled into the housing market along with other homebuyers hoping to ride the wave of rising house values.

But by 2006, a combination of higher prices and rising interest rates finally tempered demand. With affordability eroding, marginal buyers started to back off late in 2005. As price appreciation slowed, investor demand plummeted. From a peak of 9.5 percent in 2005, the investor share of prime loans fell to 7.7 percent in the second half of 2006.

Not only did home sales and single-family starts drop off sharply, but manufactured home placements also stood at their lowest level in more than 32 years (**Table A-1**). At the same time, national nominal house price appreciation slowed from the mid-teens in 2005 to the low single-digits in 2006.

ECONOMIC IMPACTS

The about-face in housing markets put an end to the big lift that the economy had enjoyed since the 2001 recession. The drop in home building was so drastic that it shaved more than a full percentage point off national economic growth in the latter half of 2006. As a result, residential fixed investment went from being a significant contributor to growth to a major drag on the economy.

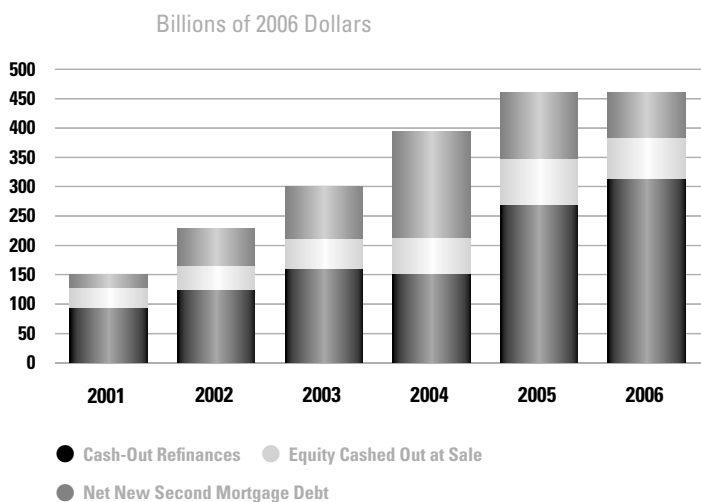
Still, one important positive remained—the support of housing wealth effects on consumer spending and remodeling. Despite significantly lower refinance activity in 2005 and 2006, the amount of home equity cashed out at refinance set records in both years (**Figure 5**). Behind this feat was a sharp increase in the share of refinancing

FIGURE 4 By Most Measures, the Housing Boom Went Bust in 2006

	2005	2006	Percent Change	
			2001-5	2005-6
Homeownership Rate (%)	68.9	68.8	1.6	-0.1
Home Sales				
New Single-Family (Mil.)	1.3	1.1	41.3	-18.1
Existing Single-Family (Mil.)	6.2	5.7	30.6	-8.1
Existing Condo/Co-op (Th.)	896	801	49.6	-10.6
Median Home Prices				
New Single-Family	\$248,671	\$246,500	24.7	-0.9
Existing Single-Family	\$226,684	\$221,900	28.9	-2.1
Existing Condo/Co-op	\$231,123	\$221,900	61.1	-4.0
Home Equity (Tril.)	\$10.9	\$10.9	31.2	0.8
Mortgage Debt (Tril.)	\$9.2	\$9.7	54.3	5.5
Mortgage Refinancing (Tril.)	\$1.7	\$1.5	15.2	-13.2
Residential Investment (Bil.)	\$795.3	\$766.7	48.9	-3.6
Improvements & Repairs (Bil.)	\$222.0	\$228.2	23.6	2.8

Notes: All values and calculations are based on 2006 dollars using the Bureau of Labor Statistics CPI-UX for All Items. Percent change is calculated with unrounded numbers. The change in homeownership rate is in percentage points.
Sources: US Census Bureau, National Association of Realtors®, Freddie Mac, Federal Reserve Board, and Bureau of Economic Analysis.

FIGURE 5 Despite the Housing Downturn, Home Equity Cashed Out Remained At Peak Levels Last Year



Note: Adjusted for inflation by the Bureau of Labor Statistics CPI-UX for All Items.
Sources: National Association of Realtors®, Freddie Mac, and Federal Reserve Board.

homeowners who took cash out. Indeed, the share climbed from about 36 percent in 2003 to about 85 percent in 2006—a level not seen since before the 1991 recession.

The amount of home equity loans and lines of credit also managed to set a new record. For the first time, second mortgage debt surpassed \$1 trillion, up from \$943 billion in 2005 (Table A-4). Although growth fell in real terms from \$112 billion in 2005 to \$76 billion in 2006, this slowdown primarily reflected a decline in the use of second mortgages to buy homes rather than a drop in cash-out second loan volume. Infusions of cash into home sellers' pockets from capital gains dipped only modestly from about \$79 billion in 2005 to \$70 billion in 2006.

With housing wealth effects still positive and homeowners holding billions in cashed-out equity, improvement expenditures set a record for the fifth consecutive year—up \$6.2 billion in real terms to \$228 billion. By comparison, spending on new construction fell by a much larger \$28 billion in 2006.

But as the inventory correction proceeds and house prices soften further, housing wealth effects are likely to turn negative. When consumers start to realize that their home values are not appreciating at as rapid a pace (and may even be falling), they will spend less liberally and borrow less against their equity. When they do, both consumer spending and remodeling activity will slow.

The magnitude of the impact will depend on how much prices fall nationally and in specific markets. The typical lag between a retreat in new construction and a cutback in improvement spending is about six months. Given the enormous amount of equity cashed out in 2006, the lag may be longer this time around. At some point, however, higher borrowing costs and weaker house prices will cause some homeowners to forgo or at least defer discretionary projects.

THE SPREADING MARKET CORRECTION

Even though builders started to cut production by the middle of 2005, it was not until the beginning of 2006 that starts nationwide fell below year-earlier levels. Completions did not begin to fall on a year-over-year basis until the end of 2006 (Figure 6).

With demand dropping off faster than production, the supply of new and existing homes for sale shot past seven months. The clearest sign of the burgeoning oversupply was a more than 500,000-unit run-up in vacant existing homes for sale from the fourth quarter of 2005 to the fourth quarter of 2006. The total supply of vacant for-sale units, plus units under construction but not yet completed, was 3.3 million at the end of last year.

Housing market conditions varied considerably across the country when the inventory correction took hold. By the first quarter of 2006, single-family permits had already turned negative on a year-over-year basis in fully half of all metropolitan areas. By the fourth quarter, 78 percent of metros had registered year-over-year declines, and 74 percent also saw permits down for 2006 as a whole. Among the 50

largest metro areas, Detroit and Sacramento were hit hardest, registering a more than 40 percent plunge in permits.

Meanwhile, production in nearly all states fell last year (**Table W-1**). Some of the earliest markets to post declines were in states with depressed economies or where heavy speculation and strong employment growth had led to overbuilding. In contrast, a few metropolitan areas—including Houston, Austin, Seattle, Charlotte, and Los Angeles—managed to show strength throughout 2006 in terms of price appreciation, employment growth, and permit activity.

But even in some areas where starts and permits slid, employment growth remained robust. These markets, along with metros that had the quickest and deepest production cuts, are the most likely

to emerge first from the inventory correction. Topping this list is Phoenix, where job growth was a strong six percent in 2006 despite a 29 percent drop in housing permits. Indeed, permits there were off by more than 50 percent in the final quarter of 2006 from a year earlier. Las Vegas had nearly as strong job growth and as large a cut in permit activity.

Other markets with a combination of generally healthy job growth and significant cutbacks in permits—including many in California, Florida, and around Washington, DC—may not recover as quickly because their employment gains are not as great and their excess supplies are still high. These markets will be bellwethers for the duration and severity of the overall correction.

MEASURING OVERSUPPLY

Except in the few areas facing real economic distress, this housing downturn has been driven largely by the market's own excesses. Chief among these is the oversupply of homes triggered by inflated demand from investors, second-home buyers, and others intent on getting in on rapidly appreciating prices.

Overbuilding does not appear to be quite as great today as in the years preceding the last major correction in 1987–1991, but it is close. One way to estimate the extent of oversupply is to consider what vacancies would have been had they remained at rates when markets were more balanced. Using this approach, the combined oversupply of vacant for-rent and for-sale units amounted to about 0.91 percent of the housing stock in 2006, compared with 1.05 percent in 1987 (**Figure 7**). In absolute terms, however, there appear to be more excess units now than during the previous cycle.

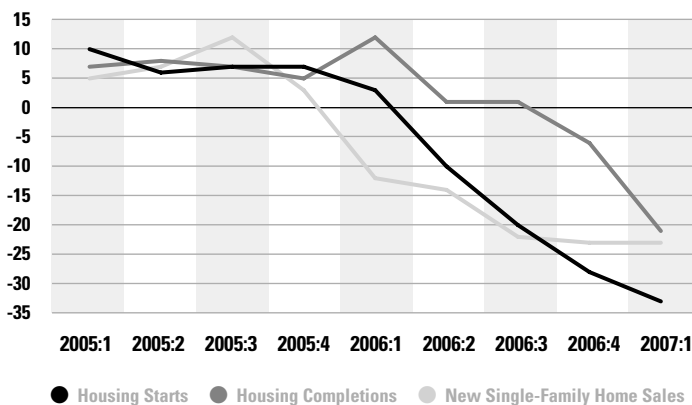
The nature of the excess inventory is also quite different. In the late 1980s, the overbuilding was on the multifamily rental side, after construction had boomed under unusually generous tax incentives early in the decade and then went bust when the incentives disappeared. This time, the single-family side is more obviously overbuilt, with both the for-sale vacancy rate (2.4 percent) and single-family for-sale vacancy rate (2.1 percent) setting new records in 2006.

As a result, single-family starts and prices are likely to undergo the biggest correction during this cycle. Single-family starts are now running about 30 percent below 2005 peak levels—nearly matching the peak-to-trough drop in 1986–1991. For now at least, the economy is expanding, adding jobs, and delivering stable and still historically low interest rates. While it is conceivable that these conditions will help stabilize starts and sales, tightening credit standards and softening prices point to further weakness in demand.

HOUSE PRICE RISKS

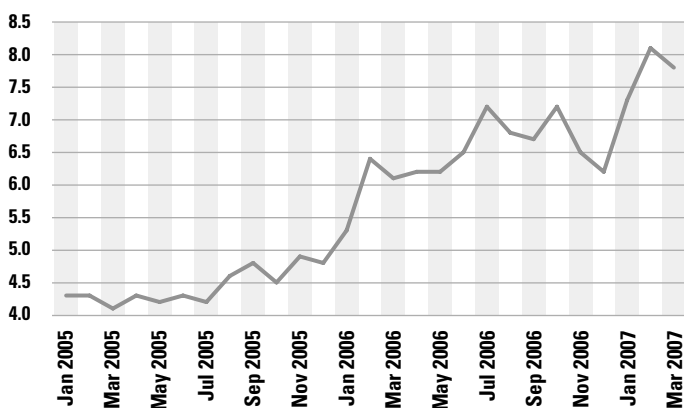
Unlike starts and sales, nominal single-family house prices held up both nationally and in the majority of metro areas in 2006. Even using the National Association of Realtors® conservative measure, median prices were down for the year in less than one-quarter of the 149 metros evaluated (**Table W-6**). The largest drop of 7.4 percent occurred

FIGURE 6 With Completions Lagging The Decline in New Home Sales...
Year-over-Year Percent Change



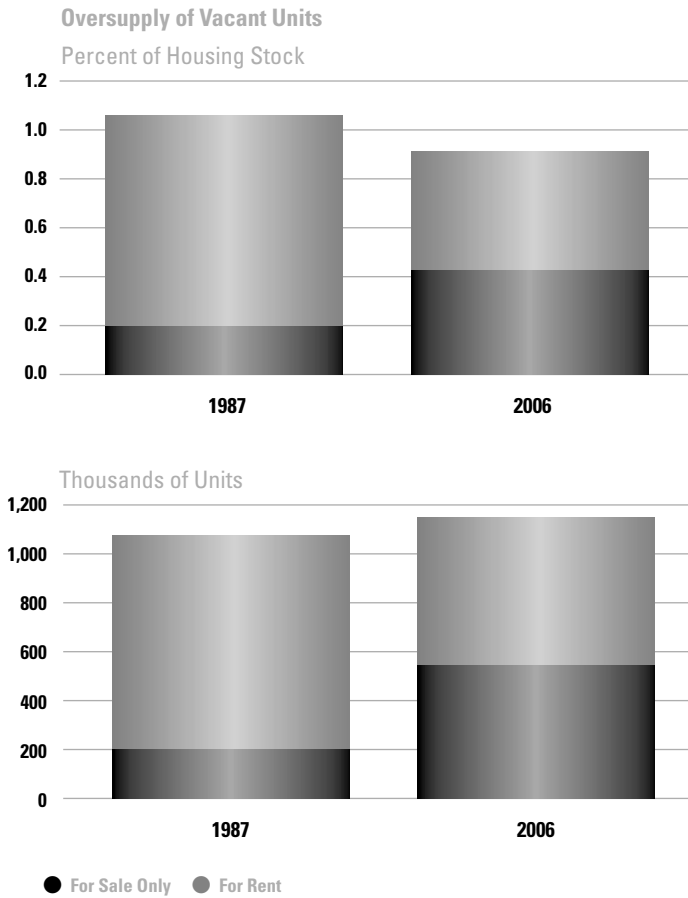
Notes: Rates are based on seasonally adjusted data. Includes only single-family homes.
Source: US Census Bureau, New Residential Construction.

...The Unsold Inventory Rose Significantly
Months Supply of New Homes for Sale



Note: Data are seasonally adjusted.
Source: US Census Bureau, New Residential Construction.

FIGURE 7 The Current Run-up in Vacancies Rivals That Preceding the Last Major Downturn



Notes: Oversupply of vacant units in 2006 is the difference between actual and predicted 2006 vacancies based on the average vacancy rates in 1999–2001. Oversupply in 1987 is the difference between actual and predicted 1987 vacancies based on average vacancy rates in 1979–1981.
Source: JCHS tabulations of US Census Bureau, Housing Vacancy Survey.

in Detroit, where employment also fell 2.0 percent. In fact, of the 11 metros that saw house price declines of more than 3.0 percent, all but two were in economically depressed areas of the Midwest.

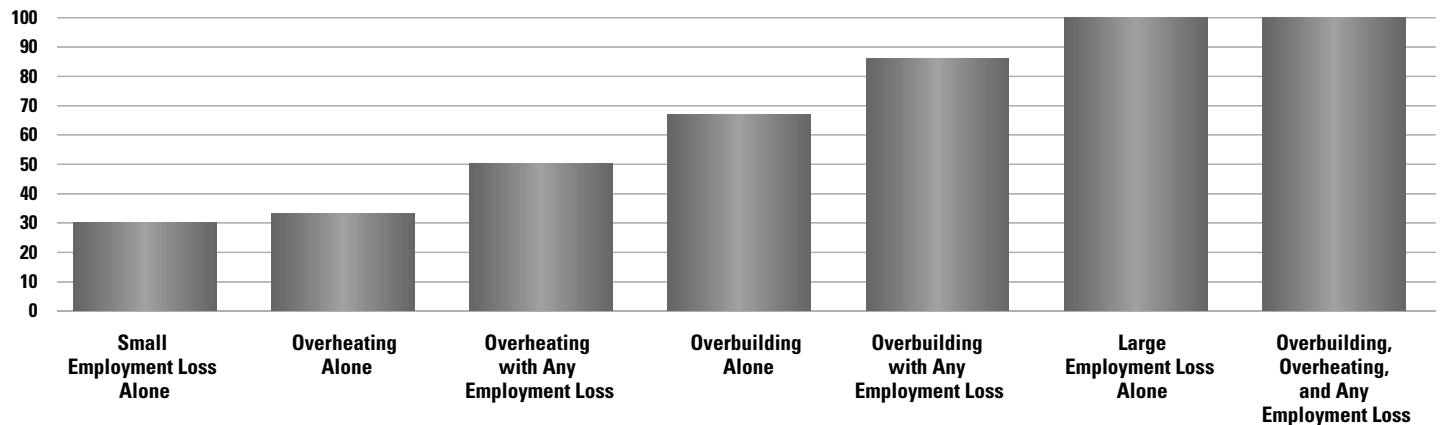
Though more volatile than annual price changes, fourth-quarter 2005 to fourth-quarter 2006 changes suggest that another 25 metro areas posted nominal price declines of more than 3.0 percent. This list includes some coastal Florida metro areas, as well as several large markets such as Dallas and San Diego. Also in these ranks are several metros that had especially strong house price appreciation, speculative buying, and overbuilding of single-family homes in 2005, such as Fort Myers, Reno, and Sacramento.

While some large markets may post significant drops merely because prices inflated ahead of income between 2000 and 2005, overbuilding and employment losses have historically been much better predictors of impending corrections than price appreciation. Indeed, the probability of any price decline—and especially a large one—is much higher in and around periods of overbuilding or a combination of overbuilding, price overheating, and employment losses than in periods of escalating house prices alone (Figure 8).

Many metro markets appear to be overbuilt when measured by the deviation of recent single-family permit intensity (permits per capita) from long-run intensity. By this yardstick, fully 148 of all 361 metros were mildly overbuilt (0–1 standard deviations from mean long-run intensity), 108 moderately overbuilt (1–2 deviations), 30 severely overbuilt (2–3 deviations), and 23 extremely overbuilt (3 or more deviations) in 2006. While an imperfect measure of overbuilding, changes in permits per capita may provide a warning of price corrections to come.

A lot is riding on how the correction in starts and sales affects house prices. Falling prices discourage sellers from selling and, more impor-

FIGURE 8 As Risks Compound, House Prices Are More Likely to Decline
Percent of Times that Conditions Led to Price Declines in 1980–1999



Notes: Instances of overbuilding and overheating are defined as periods when prior three-year average single-family permit intensity or price appreciation exceeded two standard deviations of the 25-year mean for the 75 largest metro areas combined. Metro area permit intensity is the ratio of permits per capita in a given year to their median level in 1980–2004. Small employment loss is 5% or less, and large employment loss is over 5%.
Source: Eric S. Belsky and Daniel McCue, "Why Do House Prices Fall? Perspectives on the Historical Drivers of Large Nominal House Price Declines," JCHS Working Paper W07-3, 2007.

tant, buyers from buying. They also make it harder for distressed borrowers to avoid foreclosure by refinancing or selling their homes. Furthermore, falling prices increase lender losses and ultimately turn housing wealth effects from a spur to a drag on economic growth.

THE OUTLOOK

Housing starts showed at least temporary signs of stabilizing at the beginning of 2007. If that continues, starts will still end this year down another 19 percent to about 1.47 million units. New home sales, in contrast, were still dropping in the first quarter of 2007. Even

without further declines, sales of new homes will fall about 19 percent to 857,000 for the year. Existing home sales also slid in early 2007, down 11 percent year-over-year in March.

With credit standards tightening, mortgage defaults mounting, and house prices under pressure, demand could fall further and the supply of vacant unsold homes increase. Indeed, it would take about two years of starts running at about 1.55 million and manufactured home placements at about 100,000 to work off the half-million or so vacant for-sale units added between the end of 2005 and the end of 2006.

So far, rental vacancy rates have not risen like for-sale vacancy rates, and rising rents suggest that the market is close to balance. It is therefore possible that there is no large overhang of rental units to draw down. Still, the run-up in rental vacancies over the past few years is yet another reason to believe that total production may have to retreat even further to pare excess inventory.

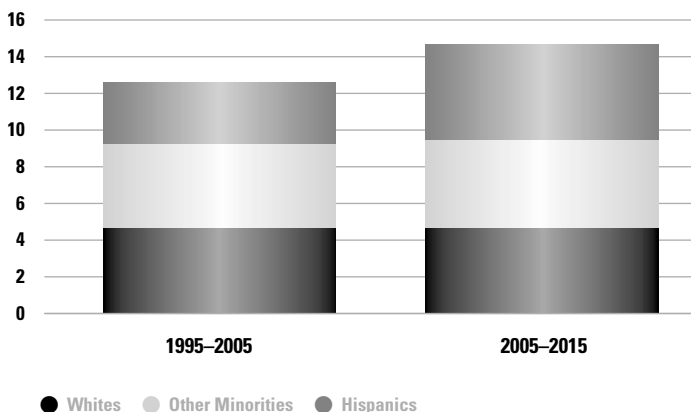
And once homeowners start to feel less secure about their housing wealth, remodeling activity will also dip. Fortunately, improvement spending is typically less volatile than residential construction spending. In the last downturn, for example, remodeling expenditures declined 8.7 percent in real terms between 1987 and 1991, and then rose 11.5 percent in the subsequent three years. By comparison, new construction spending plummeted 33 percent and then rebounded 42 percent over the same period. However, spending on major improvement projects, like room additions and kitchen and bath remodels, did tumble nearly as much as new construction in the last downturn. Indeed, it was spending on replacements of worn-out systems that kept total remodeling expenditures from falling more.

Once market balance is restored, the outlook becomes brighter. Fueled by minorities and especially Hispanics, household growth is expected to increase from 12.6 million in 1995–2005 to 14.6 million in 2005–2015 (Figure 9). As the baby boomers move into the peak vacation-home buying years with record amounts of wealth, demand for second homes will continue to grow. The aging of the housing stock will also boost demand for new homes to replace older units.

All this sums to a sustainable level of housing completions and manufactured home placements of roughly 19.5 million units in 2005–2014. Remodeling is also on a track to grow ahead of the rest of the economy. Thanks to increases in both the number of homeowners and in expenditures per household, remodeling expenditures are expected to grow at a real compound annual rate of about 3.7 percent through 2015 (Figure 10).

FIGURE 9 Hispanics and Other Minorities Will Propel Household Growth

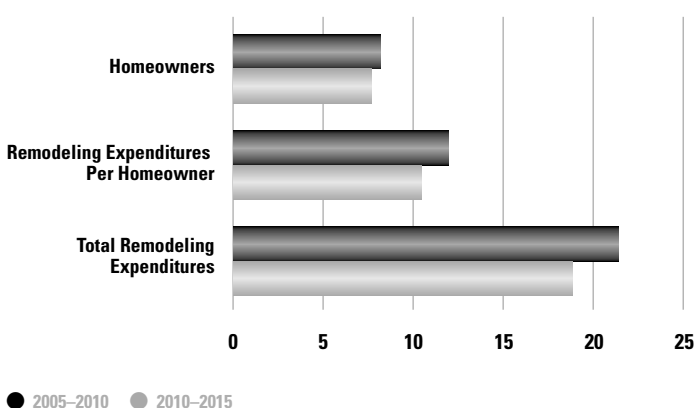
Change in Households (Millions)



Sources: JCHS tabulations of unpublished Housing Vacancy Survey tables, and George S. Masnick and Eric S. Belsky, "Addendum to Research Note N06-1: Hispanic Household Projections Including Additional Tenure Projection Detail by Age and Broad Family Type for Non-Hispanic White and Total Minority Households," JCHS Research Note N06-4, 2006.

FIGURE 10 Strong Household Growth and Increased Spending per Household Will Contribute To Future Remodeling Gains

Percent Change



Source: Foundations for Future Growth in the Remodeling Industry, JCHS Report R07-1, 2007.