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ECONOMIC NEWS UPDATE

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Very few markets are as complicated as the housing market, which may be why it so confuses market watchers. One week the New York Times reports “Healthy Housing Market Lifted the Economy in July,” the next week the same writer discovers, “July Slowing of Home Sales Stirs Talk of Market Peak.”

This confusion is no trivial matter, since the housing industry has replaced the auto industry as the driving force in the US economy. Bureau of Labor Statistics data compiled for me by Diana Furchtgott-Roth, a colleague at the Hudson Institute think tank, show that the housing and related industries now account for 4.8 million jobs, some 60% more than the once-mighty auto industry. Whereas the auto industry has desperately shed 60,000 workers in the past four years so as to reduce its future pension and health care costs, points out Furchtgott-Roth, the housing industry has created almost 600,000 jobs in the construction, mortgage brokering and other parts of the financial services industry.

Indeed, even the newspaper industry is a beneficiary of the booming

housing market: Even though 74% of US home buyers used the Internet in their search for homes, real estate ads in papers such as The Los Angeles Times and the Dallas Morning News were up 45% and 34%, respectively, according to the Wall Street Journal.

In one sense, the industry consists of a series of very local markets. As any prospective home buyer knows, the street on which a house is located, much less the neighborhood or the town, can importantly affect the value of that house. So when Federal Reserve Board chairman Alan Greenspan says that there is “froth” on some markets, he is careful to point out that we have never had a nationwide collapse in home prices, at least not since the Great Depression.

But there is another sense in which the housing market is national, rather than merely local, in scope. Interest rates and the jobs market importantly affect the affordability of houses and consumers’ willingness to take the plunge into home ownership. So the low rates that have prevailed in the United States, and the recovering

jobs market, account for the nation-wide spurt in home building and buying.

Indeed, the housing industry is no longer insulated from the globalization trends that characterize other markets. Investors from Germany to Abu Dhabi to China to Australia (our friends from Down Under have replaced Germany as the leading investors in U.S. commercial real estate) are pouring money into mortgage-backed securities, providing lenders here with still more money to lend to prospective home buyers, many of whom have substandard credit ratings. Meanwhile, proof that housing markets around the world are connected by the common forces of interest rates and job growth can be seen by looking at prices around the world. The Economist reports that the 13.0% rise in prices in the US between the third quarters of 2003 and 2004 was topped by increases in Spain (17.2%), New Zealand (16.4%), France (14.7%), and Britain (13.8%).

So will it all end in tears? Will the five-year boom that has seen average prices increase by 50% in the US (and by that much in the past twelve months in Phoenix) prove to be a bubble? After all, Goldman Sachs reports, "Relative to per-capita GDP, a typical home in San Francisco now costs much more than one in London," the housing market used by Americans as the epitome of the unaffordable. And economist Robert Schiller, famous for having warned that the stock market was over-valued before investors found to their pain that he was correct, now warns those predicting continued rises in house prices, "Beware."

Whether we will see a gradual cooling or hear the sound of a bubble bursting will depend on the interaction of all of the forces playing on the market:

the willingness of international investors to continue pouring money into mortgage-backed securities, which now exceed in market value the total of all US Treasury securities outstanding; the Fed's desire and ability to drive up mortgage rates; and very local conditions of supply and demand.

Recent data provide little guidance. Just last week the National Association of Realtors reported that sales of existing homes fell by 2.6% in July, but that sales of new homes rose by 6.5% from June, and by 28% from July 2004, to a new record. To add to the confusion, despite the July fall, sales of existing homes were 4.7% above year-earlier levels, and the median price for these already-built houses (the price at which half sold for more and half for less) was 14.1% above the level reached a year ago. But prices for new homes fell by 7.2% in July, and are now 4% below last year's level.

Ammunition for those who see in these contradictory signs evidence of weakness in the market comes from the Mortgage Bankers Association, which reports that demand for mortgages is down 8% from its June peak, and from indications that houses in some areas (San Diego and Washington, D.C. are two examples) are taking longer to sell even after asking prices come down.

In the short term, it seems likely that the sour mood created by the continued violence in Iraq and the income-drag of high petrol prices, will make consumers cautious. More important will be the prospect of steadily rising interest rates, which experience in Great Britain, Australia and New Zealand proves can not only cool the housing market but, if overdone, threaten overall economic growth.

In America, rising rates will almost certainly take some of the froth off the housing boom in some markets. Buy-and-flip investors, whose purchases “seem to have charged some regional markets with speculative fervor”, to quote Greenspan, are likely to begin to unload properties bought when “up” seemed the only direction in which prices might move. And the use of what the Fed chairman calls “interest-only loans and ...more-exotic forms of adjustable-rate mortgages ... may leave some mortgagors vulnerable to adverse events” when some \$1 trillion of the nation’s mortgage debt -- 12% of the total -- switches to adjustable payments in 2007, up from \$80 billion, or 1%, at present.

Fortunately, the longer-term outlook remains bright. Harvard University’s Joint Center for Housing Studies points out that

- Housing is still relatively affordable in 77 of 110 of the nation’s largest metropolitan areas;
- In several areas in which prices have risen most rapidly, “natural or regulatory-driven supply constraints may have resulted in permanently higher prices;”
- Household growth, and with it the demand for houses, is likely to accelerate over the next decade, with immigrants accounting for one-third of that growth;
- Baby boomers, possessed of “record wealth [are] “fueling the demand for ... second homes;

- The increase in minority first-time buyers “is dramatic.”

So if demography is destiny, things look good for homebuilders. And since homeowners don’t dump their houses, in which most have built up substantial equity as well as emotional ties, at the first sign of a price drop -- houses are not shares of stock, after all -- the danger of a nationwide significant downward price spiral seems minimal. Australia’s experience suggests that an end of price increases need not precede the start of nationwide price declines. Still, prospective buyers would do well to heed Professor Schiller’s warning: “Beware” -- of unaffordable mortgages, and tales of never-ending price increases.



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