

[Back](#)[Send to Printer](#)

When will market hit bottom?

Part 1: Dissecting the downturn

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Editor's note: With the end of a year marked by weakening housing markets drawing to a close, the question on many industry professionals' minds is "When will this market hit bottom and when will it start to recover?" In this three-part series, Inman News seeks insight from housing analysts who go deep to paint a picture of housing in 2008, compares this downturn to past cycles and seeks input from agents on how they are reacting with their business plans.

For economist Dean Baker, the next U.S. economic recession is more a matter of when than if.

"I don't know how we avoid a recession," said Baker, co-director of the Center for Economic and Policy Research, a research and public education organization.

While Baker is less optimistic about the fate of the housing market and U.S. economy, market predictions by even the most optimistic real estate and economic analysts have generally grown gloomier in the past several months as troubles in the mortgage and credit markets have boiled over.

That has led many housing-market experts to reach a common conclusion: It's worse than we thought.

The bottom of the housing market is likely deeper and wider than previously imagined, they say, so the housing slump could drag down the economy with greater force and further delay a recovery.

Problems ranging from foreclosures and unavailable mortgage loans to subprime mortgage-company bankruptcies and skyrocketing losses associated with mortgage-related securities have sent shockwaves from Main Street to Wall Street.

Home sales have dropped off substantially and home prices are falling in many markets.

The global nature of mortgage financing has entwined the course of the United States' real estate downturn with factors outside of this nation's control, and troubles in the U.S. housing market and economy may likewise signal a host of international financial problems.

"We're really at the beginning of this," Baker said, noting that the unprecedented run-up in U.S. housing prices fell out of line with inflation and other fundamentals. "My expectation is that the bulk of that run-up will disappear."

A recession, he noted, "can be hard to recognize even when it has already begun."

While Baker said it doesn't appear that the United States has entered a recession yet, he said he is surprised to see continuing strength in some segments of the economy despite other downward trends.

Employment numbers have shown some resilience, he said, though many jobs are low-paying and don't offer much in benefits.

Also, while home ownership reached record levels during the latest housing boom, the rate of equity to value is at a record low as people have borrowed against their homes, Baker noted.

The economic recovery that followed the technology bubble and stock crash in 2001 was aided by growth in the housing market, and this time around there may not be another similar crutch to prop up the economy.

"What I worry about with this recession ... it might be very hard to get out of," Baker said.

He expects more of a slow, drawn-out bottoming and recovery cycle. "The unraveling could take two to three years."

It could be quicker, he said, if there is widespread real estate panic and the market floods with home sales and corrects more rapidly. Some markets have already been inundated with for-sale inventory.

Ken Rosen, chairman of the Fisher Center for Real Estate and Urban Economics at University of California, Berkeley, said during a [mid-November presentation](#) that a recession is becoming more likely and it's prudent to plan for the worst, though he says there is still a 55 percent chance that the nation will avoid a recession.

Home prices may continue to fall another 5 percent to 7 percent nationally before the market turns around, he said.

Pressure on home prices

Economist Robert Shiller said during a presentation in late November that a recession is more likely than not, and he also said it would not be a surprise to see massive home-price declines. "I think we are in a period of exceptional uncertainty about the value of our homes."

The Standard & Poor's/Case-Shiller U.S. National Home Price Index -- an index that Shiller helped establish -- dropped 4.5 percent in the third quarter compared to the same quarter last year and dropped 1.7 percent compared to the second quarter, which represents records in the 21-year history covered by this index.

And the [Office of Federal Housing Enterprise Oversight reported](#) the first quarterly decline in average U.S. home prices in 13 years for the third quarter -- down 0.4 percent -- based on a separate price index.

Another index released by the National Association of Home Builders and Wells Fargo found that the [national median price of new and resale homes](#) sold in the third quarter dropped 3.6 percent year-over-year, and the National Association of Realtors [reported](#) a 2 percent year-over-year decline in the resale home price in the third quarter.

The U.S. Census Bureau and Department of Housing and Urban Development reported that the median [sales price of new homes](#) slid 13 percent in October compared to October 2006, and the Realtor group reported that the median price of U.S. resale homes fell 5.1 percent year-over-year in October.

National home sales have been dropping, too, while the volume of foreclosures has been rising.

The foreclosure problem will likely be with us through 2009, said Mark Dotzour, "The foreclosure situation nationally ramped up pretty dramatically in 2007 and will continue all the way through 2008 and well into 2009 as well, and then it's going to fall off pretty abruptly in the first quarter of 2010," said Mark Dotzour, an economist at Texas A&M University.

He said there is still a steady stream of adjustable-rate mortgages that are heading for a reset in rates during this period, which he likened to "sticks of dynamite where the fuse has already been lit."

Loose mortgage underwriting standards during the boom have created a sort of "renter" class among homeowners who cannot afford their payments and will be forced to leave, he said.

"We just had thousands of families move into homes thinking they were homeowners, when basically they are just 'renters' with no equity in a home and no hope of getting equity in a home."

In addition to problematic mortgages and rising foreclosures, home builders have contributed to the market downturn by overbuilding in some markets, Dotzour said, which has led them to offer discounted prices and other incentives.

That, in turn, has put downward pressure on resale-home prices.

"People have been asking me, 'When are we going to start to see a turnaround in housing?' The very first sign is when builders offer homes for sale without concessions," he said.

Builders also must pull back more on home production, he added. "I don't think we'll even start the beginning of a turnaround until we see a significant further reduction in the amount of houses being built.

"The fact is they're still building too many homes. Unfortunately what we'll have to see is a large segment of the home-building industry withdrawing from the market totally, either voluntarily or through bankruptcy."

Despite efforts to reduce inventory by offering incentives and cutting production, several large public home builders have reported huge multi-million-dollar quarterly losses. And many builders have cut staff to help reduce costs during this downturn.

Some builders have exposure to the subprime mortgage meltdown and credit crisis, too, through subsidiary lending divisions.

Dotzour said he expects the housing market to regain some balance in supply and demand in 2010, "barring any sort of spectacular government intervention."

The federal government may intervene to prevent the foreclosure situation from getting out of hand, he said, though political actions could "exacerbate the problem rather than help it," and the upcoming election year may increase the probability that Congress or the president "will do something dramatic to make political points."

Today's downturn more severe

Nicolas Retsinas, director of Harvard University's Joint Center for Housing, said it appears this housing slump is more severe than most, and it may be 2009 "before we start to see even a modest recovery."

If it weren't for the credit problems in the mortgage market, housing may have been ripe for a recovery in 2008, he said. "Credit is the lifeblood of housing in this country, and the squeeze basically shut off demand."

A surge in foreclosures could be "the last shoe to drop" in this downturn, he said, and could lead to a "more dramatic falloff in prices."

Jobs are a key indicator for the economy, Retsinas said, and if the nation continues to add jobs then the economy could weather the impact of the housing downturn and avoid a recession. "If people are still working we will find our way through this."

The mortgage and credit market problems have sparked a renewed interest in government regulation of the mortgage industry, Retsinas also noted.

The Federal Reserve has taken some actions that are intended to prevent the credit crunch from snowballing into an economic disaster, though Retsinas said that recent Fed interest-rate cuts haven't provided much of a lift for the housing market.

"I daresay the Central Bank of China probably has more to do with interest rates than the Fed," he said.

Ed Leamer director of the Anderson Forecast, a quarterly economic forecast produced at the University of California, Los Angeles, said that Fed actions in setting rates won't have much impact "until we start getting stable, appreciating prices."

Leamer is more optimistic than some economists about when the housing market will turn the corner. Foreclosures will likely peak in 2008, he said, and return to a normal level.

His expectation is that the housing market "will stop being a drag on growth in mid-2008 but will not experience a rapid bounce-back. No recession, this time."

Rising home prices will be the clearest signal that the real estate market is in a recovery phase, Leamer said.

"Excessive appreciation drove the market up, and now prices are declining. We need a half-year or more of rising prices to get the sense of urgency back into home buying. That is going to take awhile, which means expect a painfully slow recovery," he said.

Actions by Congress or federal regulators that are aimed at assisting distressed homeowners may realistically have more of an impact on the next real estate market cycle than on the current one, said Jonathan Miller, executive vice president and director of research for Radar Logic Inc., a New York-based real estate research and analytics company.

"I think there will be more quick fixes in the election year than there will be long-term solutions," he said.

Miller, who notes that local real estate markets are unique and some are faring quite well, said that nationally he doesn't expect to see the market hit bottom until 2010. "I think we've got more than two years -- probably two-and-a-half years to go," Miller said.

"This is not a short-term situation. The inventory overhang is so significant and sales have dropped so much over the last year and a half that it's going to take a long time to absorb the inventory."

Miller last year wrote in his blog that he expected the nation to enter a recession in 2007 or in early 2008, and "I still believe we're going in that direction," he said.

"One of the things that has always amazed me in discussions about the economy ... is that we have this disconnect from what the housing market is actually doing and what its potential impact to the economy is."

The health of the housing market is vital to the health of the economy, he said.

Whether or not you believe the United States is headed for a recession, the answer will likely become more clear in the first quarter or second quarter of 2008, said Josh Bivens, an economist for the Economic Policy Institute, a nonprofit, nonpartisan economic think tank.

"I expect the housing market to be awfully tough through the entirety of 2008," Bivens said. "My guess at a recession in the next year is at about 50-50 -- housing is the number one reason why I'm that concerned about it."

It remains to be seen how heavily the economy relied on mortgage-equity withdrawals, as "soon that's going to fall to zero," he said. If nothing can replace those withdrawals as an economic engine, "then we'll have a recession."

Home prices will probably continue to fall into 2009 as rental prices and home prices close a gap that had dramatically widened during the housing boom, Bivens said, adding that he wouldn't be surprised if home prices remain "really flat for a long time."

Soaring home-price growth of the up-cycle has led us to "uncharted waters," and if the nation does enter a

recession then prices could fall steeply. "How much will home prices fall? It has me worried."

If you apply the same type of price correction relative to past market cycles, Bivens said it is possible prices could fall 25 percent nationwide.

"Historical experience says that's definitely a possibility and how the economy responds to a fall like that is a real worry," he said.

He expects that the impact of foreclosures will stretch beyond economically depressed markets like Detroit and Cleveland and hit markets like Boston and Washington, D.C.

He shares the view of several other economists that legislative actions will probably not stop the market's overall trajectory.

Also, he believes the global economy will suffer if the U.S. economy falters. "It's hard to imagine global growth being that good without the U.S. economy dragging it along."

What's your opinion? Send your Letter to the Editor to glenn@inman.com.

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