


Housing's New Reality

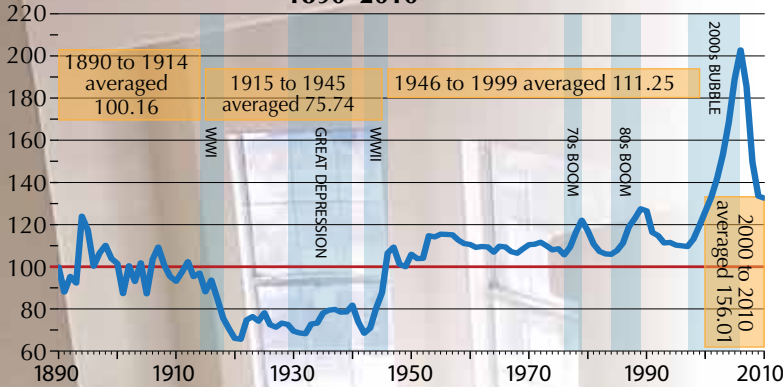
By James P. Gaines

Home values have taken a beating the past several years. The Federal Reserve estimates U.S. households lost nearly \$6.7 trillion in home equity since 2005, nearly half the total value.



As households lost wealth and the rate of appreciation in home values turned negative, house pricing based on housing consumption replaced capital gains as the primary motivation for homeownership. The market adjustment in pricing attitude means current house prices correlate more closely with existing, competitive house rents rather than hoped for, uncertain profits. This process is similar to pricing stocks based on current dividends rather than expected future positive changes in the stock price.

Figure 1. Long-Term Real Home Price Index 1890-2010



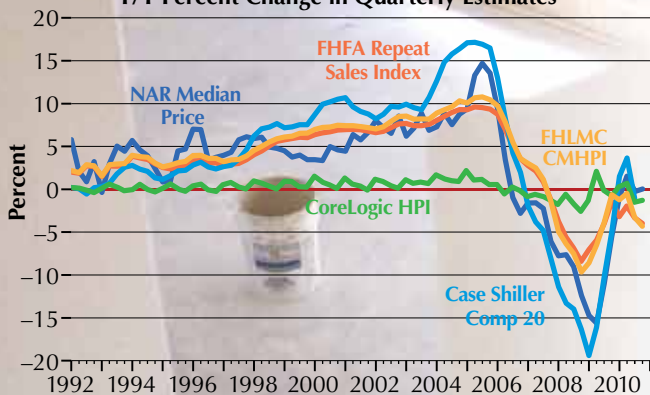
Sources: Robert J. Shiller, *Irrational Exuberance*, 2nd Ed., Princeton Univ. Press, 2005, 2009, Broadway Books 2006, also *Subprime Solution*, 2008, as updated by author: <http://www.econ.yale.edu/~shiller/data.htm>

U.S. home prices entered an unprecedented bubble in 1997 that peaked in 2006, according to the long-term, inflation-adjusted home price index created by Dr. Robert Shiller (Figure 1). All bubbles, literal or figurative, will burst if expanded beyond capacity.

According to Shiller's historical price index, real home prices increased about 10 percent from 1890 to 1997. Of course, home values mushroomed in inflated dollars but not as much in constant dollars. A \$100,000 house in 1890 would sell for an estimated \$109,639 in real (inflation-adjusted) terms in 1997 but for \$2,291,685 in inflated 1997 dollars.

Home prices took a precipitous drop in 2007 that lasted for several months but appeared to be rebounding during most of 2009 and early 2010. Some short-term measures of home price changes recorded positive appreciation after many months of decline. However, the most recent data indicate that national home prices may be headed for a so-called "double dip" this year.

Figure 2. U.S. Home Prices Y/Y Percent Change in Quarterly Estimates



Sources: NAR, FHFA PO Index, Case Shiller, FHLMC, First American CoreLogic

There are many national home price indexes (HPI) and sources of home price changes (see "When Data Collide," *Tierra Grande*, June 2009). While all have inherent differences, they tend to move in the same direction, with the magnitude of changes varying. The five major home price indicators tracked in Figure 2 suggest another round of declining home prices is occurring.

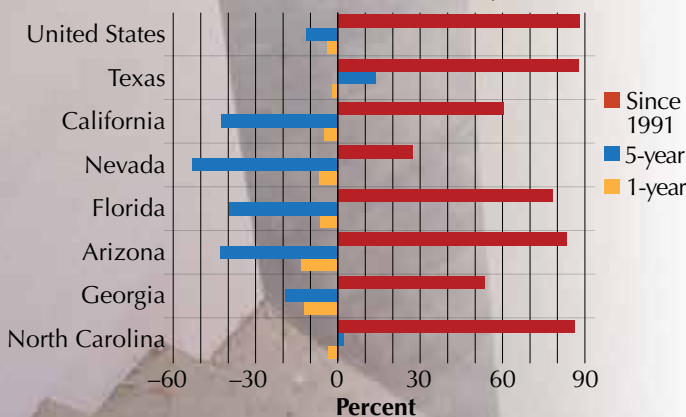
In fourth quarter 2010, all of the indices except the NAR median price (0.2 percent) indicated a decline in prices. Despite all the government's stimulus efforts in the housing market, home values still may not have hit bottom. In fact, the stimulus efforts themselves probably delayed market stabilization by shifting demand forward to take advantage of the benefits and depleting future demand that could lead to recovery.

Recently revealed problems in the foreclosure process will further delay market recovery by postponing the entry of additional properties that need to clear the market. Economists from major economic and investment firms around the country are generally projecting national home prices will fall another 5 percent to 12 percent in 2011. But these changes will be localized; not every area will have the same experience.

According to the Federal Housing Finance Agency (FHFA), during the past year, home values in 40 of 51 states (including the District of Columbia) fell in value. Over the past five years, home values in 28 states declined. Among the larger, fast-growing states, only Texas and North Carolina home values increased during the past five years (Figure 3). Texas home values rose more than those in any of the larger, high-growth states as measured since 1991. Nevada, California, Florida and Arizona had the greatest declines since 2005.

Home prices in Texas' metro areas held up extremely well in the market downturn. Many metro area house prices doubled since 1991, and every community's values increased during the past five years (Figure 4). Since fourth quarter 2009, results are mixed, but only one community, Corpus Christi, declined more than 5 percent. Most of the rest of the declines were only 1 or 2 percent. The negative effects on home prices hit most Texas markets later than the rest of the country.

Figure 3. Percent Change in House Prices Selected States as of Fourth Quarter 2010

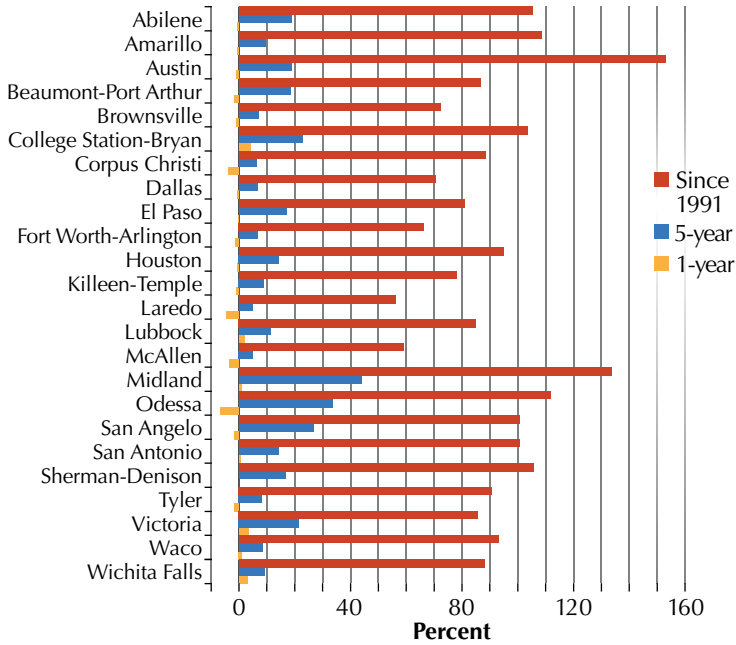


Sources: FHFA, SA, PO Index

A Changing Housing Market

One new reality is that more households, either by choice or by circumstance, will rent rather than own their housing. Nationally, homeownership slipped from a historical high of 69

Figure 4. Percent Change in House Prices Texas MSAs



Source: FHFA 4Q2010

percent of all households during first quarter 2005 to around 67 percent currently and is trending toward the 64.5 percent average that prevailed from 1971 through 1997.

Since 2007, almost 4.8 million homes have been posted for foreclosure sale, along with many more short sales and other distressed sales. This means around five million households entered the rental housing market during the past four years and will not be eligible to purchase a home again for several years. Recent increases in rents and occupancy rates give evidence of the increased demand for rental housing.

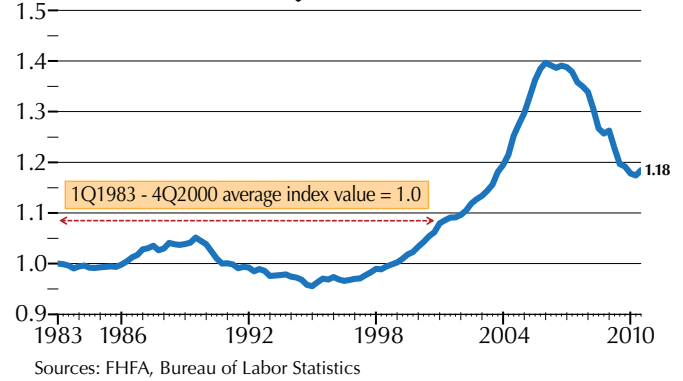
To the extent that home prices reflect buyers' evaluations of current housing services rather than inflated expectations about future home values, prices may be reflected in a price-to-rent ratio similar to stock prices reflecting a price-to-dividend relationship. A price-to-rent ratio based on the FHFA home price index compared to the Bureau of Labor Statistic's Owner's Equivalent Rent depicts the house price bubble that began in the late 1990s (Figure 5).

In principle, house prices are a function of house rents, and the long-term normal ratio should be close to 1.0. When the ratio is more than one, home prices are high relative to rents, generally because of some market aberration (short-term limited supply or abnormally low interest rates) or excessive expectation of appreciation.

The current ratio suggests that home prices remain about 18 percent overpriced compared to present rent levels. As rents rise and/or prices fall, the ratio will converge toward 1.0.

Another part of the new housing market reality is tighter credit underwriting requirements that force potential homebuyers to

Figure 5. Price-to-Rent Ratio
Quarterly FHFA HPI Index to BLS Owners' Equivalent Rent
1Q1983=1.0

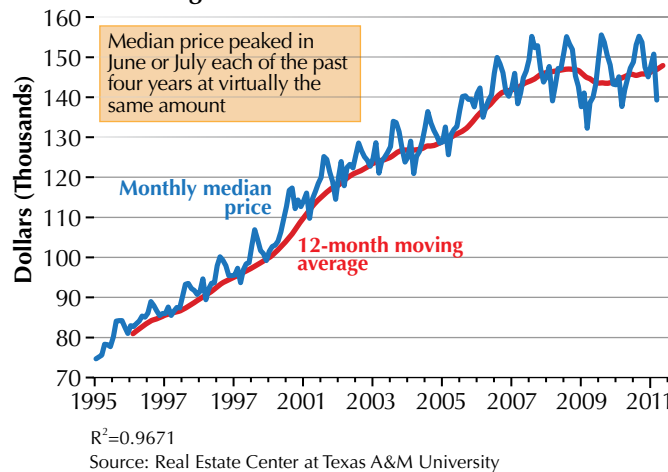


take on less debt so that total housing costs are more affordable. This reduces effective homebuyer demand as fewer households can qualify to purchase a home or must buy a less expensive home. First-time buyers are diverted to FHA loans or to renting.

Nationwide, the median-price-to-median-income ratio has dropped from its peak of 4.8 in 2005 to 3.3 in 2010. A ratio of around 3 is generally considered normal. In Texas, the ratio declined from a peak of 3.3 to a current 2.9, another indicator of how Texas avoided a price bubble during the housing boom.

A decline in demand mixed with an increasing supply of unsold properties is a recipe for falling prices. In addition to the nearly five million households entering the rental market, the same number of properties entered the "for sale" market. Estimates range from nine million to as many as 12 million houses in current inventory, with more being added each month, to be absorbed in a market that averages between five million and six million sales per year. Realistically, it will take 1.5 to 2.5 years to get the overall housing market into some semblance of balance.

Figure 6. Texas Median Home Price



R²=0.9671
Source: Real Estate Center at Texas A&M University

Single-family units for rent are a growing and increasingly significant segment of the housing market. An active single-family investor market will be critical to clear many of the foreclosed and other problem properties, not to mention to provide needed housing for former homeowners. From a policy perspective, many of the government stimulus efforts might generate better overall market results if they were focused on assisting this segment of the market.

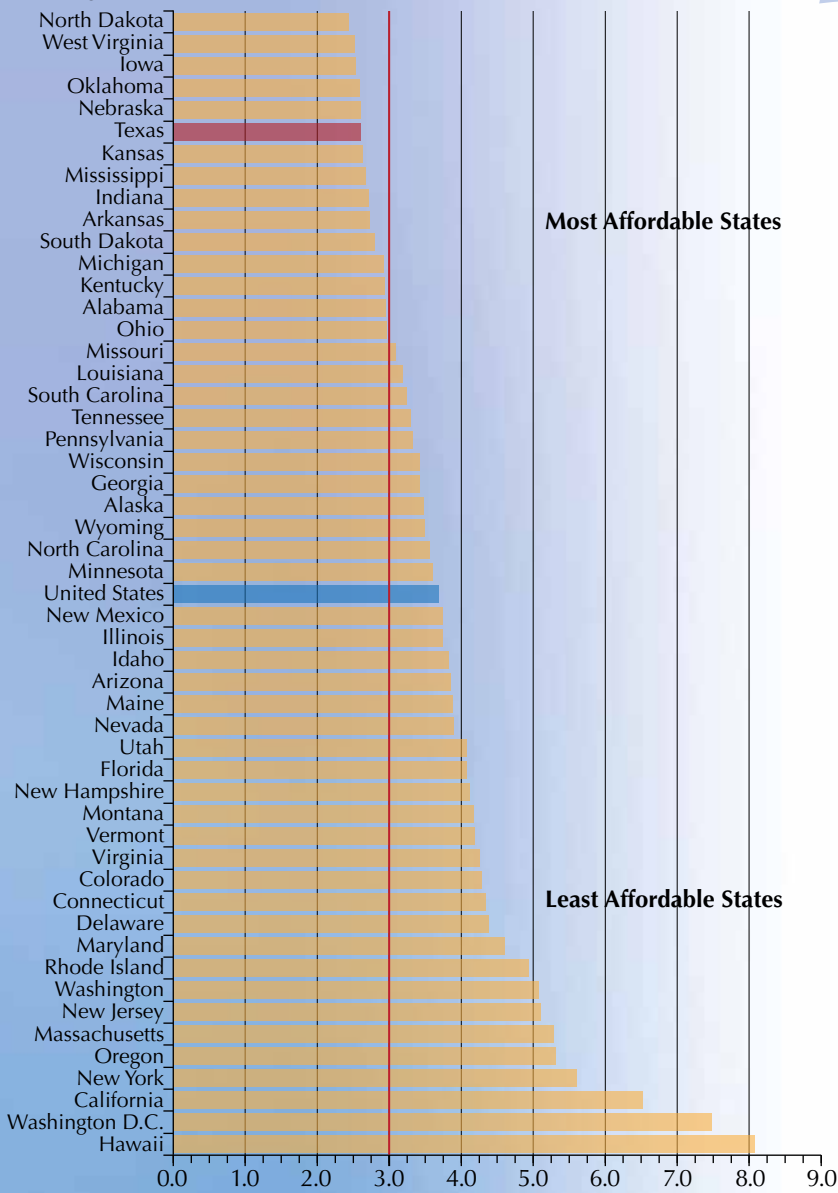
The new housing reality for 2011 (and perhaps longer) reflects

changes in household decision makers' spatial and locational preferences. Many newer households prefer smaller, higher-quality homes located in inner-urban, mixed-use neighborhoods rather than the sprawling suburbs.

New generational preferences affecting demand for houses will forge a different kind of residential marketplace during the coming decade. Younger, smaller households (fewer children and children added later in the marriage cycle) have significantly different housing needs, desires and preferences than aging baby boomers.

Texas Home Prices

Figure 7. 2009 Median Home Value/Median Household Income



Source: 2009 American Community Survey, U.S. Census Bureau

Texas home prices have held up well while those in the rest of the country generally declined. Most of the metropolitan areas in the state experienced price increases during the past five years, although increases were lower in 2010.

Home prices throughout the state typically experience consistent seasonality, peaking in the summer and falling in the winter. From 2007 to 2010, the peak summer price has been virtually constant. The amplitude of the changes from peak to trough each year, though, has been the greatest during these years (Figure 6).

The big question is whether the annual peak can be reached again without the major government stimulus efforts of the past couple of years. For now it appears that Texas home prices have stabilized, and 2011 should look somewhat similar to 2010. However, the nation may record further declines.

Texas has been and will continue to be one of the most housing-affordable states in the country. Housing affordability and new job formation are key to the state's future growth. One measure of affordability is the ratio of median home price to median household income. As 2009 American Community Survey data reveal, Texas ranks as the sixth most affordable state in the union (Figure 7).

Nationally, slack job growth coupled with tighter mortgage underwriting means overall demand for homeownership will be constrained while the inventory of properties for sale continues to climb. Disequilibrium of this type inevitably means prices will fall.

For Texas, the main problem on the demand side will be more restrictive lending requirements as the state continues to add jobs. Fortunately, the state's supply of unsold properties is not as high or as widespread as in other states. Some areas may experience price increases as the year progresses.

Sales volume statistics for the first half of the year will inevitably look depressing as data are compared with the government-stimulated sales during spring 2009. Value increases in 2011 will be low to modest for most of the state and will vary, sometimes significantly, among and between different market price segments. The second half of the year will begin to tell the story of recovery that will probably not pick up steam until 2012 and 2013. ♣

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THE TAKEAWAY

The housing market just ain't what it used to be. Expect the number of households choosing to rent to go up, credit underwriting to remain tight, inventory of available properties to continue to rise, and Texas home prices to remain stable through 2011.





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