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US Economics

Bust, Not Rust?

What's New: Two measures of home prices have declined in August from year-ago levels. Is this the beginning of a housing price bust, or the start of stagnation ("rust") as I expect? As I see it, there are downside risks, but builders' aggressive cuts in starts and support from income and job growth still make a bust unlikely.

Conclusions: The decline in price gauges of houses sold has the direction right, but overstates moves in nationwide home prices both up and down. That's because changes in the mix of homes actually sold heavily influence those metrics even over a year. Measures that are more reliable show a deceleration but no decline.

Market Implications: Bonds are priced for a weak outcome — a possible home price bust and a consequent flattening in growth in consumer spending. In contrast, equities are priced for a more benign result. The irony is that the sharp downdraft in yields is promoting increases in financial wealth that may be a significant offset.

Risks: An extended period of home price stagnation lies ahead, and given the magnitude of the coming inventory adjustment, the near-term risks for home prices are tilted lower. But the faster the builders cut starts, the faster the mismatch between sales and production will be reduced and the pressure on prices will abate.

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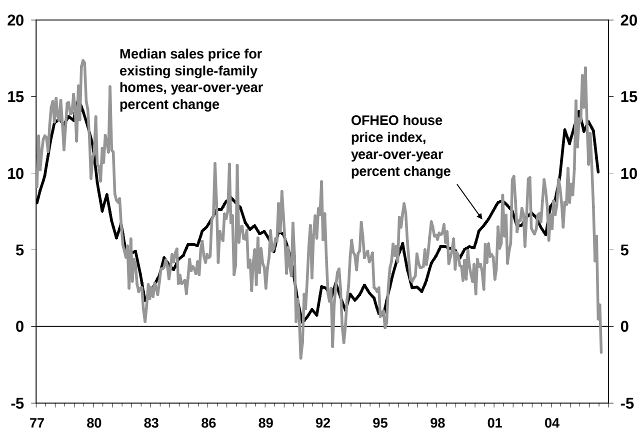
Bust, Not Rust?

For several years I've argued that the US housing boom had not created a nationwide housing bubble, and that the end of the boom would not promote a housing price bust, meaning nationwide declines in home prices. But the decline from a year ago in two nationwide measures of home prices strongly challenges that view. The median price of new single-family homes sold dipped by 1.3% and that for existing single-family homes sold fell by 1.7% in August from year-ago levels. Moreover, I think the housing recession now underway has further to go. So is this the beginning of a housing price bust, as many argue? Or is it simply the start of stagnation in prices, or "rust," as I have expected?

As I see it, there are downside risks, but builders' aggressive cuts in starts and support from income and job growth still make a bust unlikely. Measured realistically, we expect that inflation-adjusted housing prices will decelerate from a 6.6% rate in 2Q06 to zero over the next 9-12 months, and the deceleration will be sharper in nominal terms if our forecast of declining headline inflation is accurate.

Exhibit 1
A Tale of Two Home Price Measures



Source: National Association of Realtors, Office of Federal Housing Enterprise Oversight

There's certainly no perfect measure of home prices, but measurement isn't just a technical issue in the case of home prices, where no two homes are exactly alike. The good news is that all home price measures are telling a similar directional story. But the degree of deceleration or decline varies substantially, and some measures are seriously distorted. Indeed, some of these commonly-cited pricing metrics can be misleading when looked at over periods less than two years.

The Census Bureau's average and median home prices (in dollars) for both new and existing homes sold each month are cases in point. True, median price composites are superior to average quotes because the upward drift in housing quality biases the average change higher. Yet shifts in the size or value composition of sales will still heavily skew the median price measures for new home sales because these metrics inherently compare apples and oranges — the homes that happen to be sold this year with those sold last year. A shift to sales of more expensive houses will boost the median with no underlying change in the price of comparable units. The index of median prices for sales of existing homes is similarly flawed. That partly explains why the former rose by 3.4% in the year ended in December 2005, while the latter jumped by 10.6% over the same period. And shifts in the mix of houses sold explain why even the median price of new homes has decelerated so rapidly over the past year. The median price stood at $237,000 in August. But sales of new homes priced over $300,000 tumbled between 25% and 36% over the past year, while those priced up to $300,000 declined by 14-19%. The bigger plunge in sales of more expensive houses has depressed the median.

Exhibit 2
Comparing Home Price Metrics

	Frequency	Source	Seasonally adjusted?	Quality adjusted?	Most recent datapoint	1-yr % chg	5-yr % chg
Median price of new single-family home sales	monthly	Census Bureau	No	No	Aug 2006	-1.3%	36.4%
Median price of all existing homes sold	monthly	National Association of Realtors	No	No	Aug 2006	-1.8%	43.3%
Median price of existing single-family homes sold	monthly	National Association of Realtors	No	No	Aug 2006	-1.7%	40.5%
OFHEO house price index (single-family homes)	quarterly	OFHEO	No	No, matched sample	2Q06	10.1%	56.5%
Constant quality home price index	quarterly	Census Bureau	No	Yes	2Q06	4.5%	33.1%

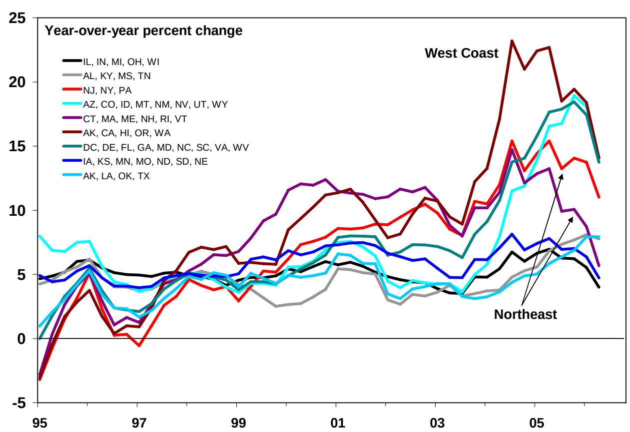
Source: Morgan Stanley Research

In contrast, the Office of Federal Housing Enterprise Oversight (OFHEO) home price index (HPI) — one of the more reliable home price measures — increased in the second quarter by 10.1% from a year ago. That is the slowest year-on-year pace in two years, and the quarterly gain of 1.2% is the slowest pace since 4Q99. Another relatively reliable measure, the Census Bureau's constant-quality home price index, increased by only 4.5% from a year ago and just 1.8% in the quarter.

The OFHEO nationwide price index and other so-called 'matched sample' popular price gauges are the most reliable price metrics. They track repeat sales of the same single-family properties and thus eliminate most of the mix shift problems inherent to other measures. But even these gauges may overstate 'pure' price appreciation in housing, because they don't take remodeling into account. That is, owners added to the value of the property by investing in additions and alterations, but the index (which is designed for housing intermediaries Fannie Mae and Freddie Mac, not for economic analysis) isn't adjusted for such increases in 'quality.' The difference can be substantial: The Census Bureau's index of median new home prices rose by 47.3% in the five years ended in 2005, while a similar index adjusted for quality rose by one third less, or 32.4%. In addition, 'appraisal bias' may inflate the OFHEO measure; a 'purchase-only' version of the OFHEO measure shows that home price appreciation peaked at 11.3% a year ago and ran at 8.3% in the year ended in June.

Exhibit 3

OFHEO Home Price Index by Census Region



Source: Office of Federal Housing Enterprise Oversight

But measurement issues should not obscure the real debate over the house price outlook. Pessimists argue that the bursting of a putative housing bubble means that prices could decline significantly. There is some risk that prices could decelerate faster or even decline — after all, investor and speculative activity in housing has picked up in the past five years. As evidence, Home Mortgage Disclosure Act (HMDA) data suggest that the investor share of sales (including vacation homes) rose to 13-15% by 2004 or double the proportion from five years previously. Those local markets with extremely high investor shares (Las Vegas 24%, Orlando 19%) seem more susceptible to outright price declines.

In my view, the deceleration in prices has been the product of two factors: Sinking housing affordability that undermined demand and builder exuberance that created an overhang of new supply and inventories of unsold homes. Because housing demand in the short run is relatively insensitive to price changes, a buildup in inventories can produce a sharp deceleration in prices. But that also implies that builders' aggressive efforts to slash housing starts and cut back inventories will promote a better supply-demand balance and help to stabilize prices. And just as accelerating price changes eventually hobbled demand, I think a sharp deceleration in prices will help stabilize it, perhaps at levels 15% lower than today. Investors thus should not assume that a bust in housing activity will promote more than rusting home prices.

Nonetheless, prices may fall in markets that are affected by a weak economy (e.g., Detroit), by high speculative activity (e.g., some condominium markets), or where there is a preponderance of second homes (e.g., in Florida or the Sunbelt). Ironically, home prices in the Gulf Coast and Florida have fared quite differently in the year following the destructive 2005 hurricanes: The supply shock that reduced the housing stock and caused a scramble for new places to live in the Gulf Coast has led to price hikes of 15-20% in New Orleans-Metairie-Kenner and Baton Rouge, LA and Gulfport-Biloxi, MS. Contrariwise, the sharp escalation in insurance premiums and the difficulty in obtaining homeowners insurance at all has added to downward pressure on Florida home prices. Those disparities underscore the fact that local economic conditions are typically the dominant forces driving home prices.

A comparison of price changes over the four quarters of 2005 with more recent data is instructive. According to OFHEO, four-quarter appreciation rates in 2005 were at record levels in 26 metropolitan areas including Orlando-Kissimmee, FL; El Paso, TX; and Myrtle Beach-Conway-North Myrtle Beach, SC. Phoenix-Mesa-Scottsdale, AZ was the MSA with the greatest appreciation rate of 39.7 percent. By state, Arizona's appreciation was 34.9 percent, or more than eight percentage points greater than the rate in Florida, the second-fastest appreciating state. As a result, the Mountain Census Division became the fastest-appreciating area of the country.

More recently, Arizona and Florida have shown sharp decelerations in home prices that really began in the spring of 2005. The year-over-year arithmetic masked those changes. Recent monthly changes (unpublished) for both states imply annual increases in the low single digits. Price declines in these states are possible. By contrast, appreciation patterns for the two states with the lowest overall appreciation, Ohio and Michigan, showed minimal deceleration over that period, although the MSAs surrounding Detroit are beginning to show weakness in response to job losses in motor vehicles and auto parts and the exodus from the region.

More generally, the OFHEO analysis confirms that the sharpest decelerations are occurring in the MSAs and states that had the biggest run-ups in price. While that strongly hints at the unwinding of local bubbles, it may not be the case everywhere that "the bigger they are the harder they fall." And rapid home price increases alone aren't sufficient to conclude that a bubble existed; to create a bubble, in our view, you need rapid price increases that go beyond local economic fundamentals. Metrics for making those judgments, such as home-price-to-rental price or home-price-to-income ratios, offer only limited guidance. In any case, the reality is that prices won't stop decelerating until the excess inventory of new homes has been mostly worked off and housing affordability begins to turn up.

The dichotomy among financial market participants clearly reflects their views on the outcome of the housing debate. Bonds are priced for a weak outcome — a home price bust and a consequent flattening in growth in consumer spending. In contrast, equities are discounting a much more benign result. The irony is that the sharp downdraft in yields is promoting increases in financial wealth that may be a significant offset.

An extended period of home price stagnation lies ahead. Given the magnitude of the coming inventory adjustment, the near-term risks for home prices are tilted lower. But the faster the builders cut starts, the faster the mismatch between sales and production will be reduced and the pressure on prices will abate.

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