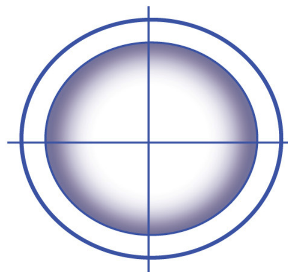

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Are We There Yet?

Have We Reached a Definitive Housing Bottom?

May 17, 2012 by William L. Pittenger, MAI, SRA

Opinions are mixed about whether or not the housing market has found a definitive bottom. Buyers, sellers, agents and builders anxiously await some sort of "all clear" signal to be sounded before they jump back into the market. News stories are replete with wishful thinking and hopes that the bottom is here and the housing market will soon change direction; pent up demand will be unleashed and both sales volume and prices will surge upward. Whether the market has reached a definitive bottom is still arguable. While a bottom would lead to more consumer confidence and move some off the sidelines, the bigger story is what happens next and what the short and mid term future might hold for housing.

After five years of unprecedented housing distress, affordability is now at an historic high due to record low mortgage interest rates and existing home prices that have retreated to levels last seen early last decade. In many areas, inventories too have fallen as much as 40% to roughly 2005 levels. In some areas that has actually led to shortages which have even pushed prices up and generated multiple offers on a single property, something we have not seen since before the housing collapse. This is especially true in California in the under $500,000 category although there are similar anecdotes from South Florida and other areas.

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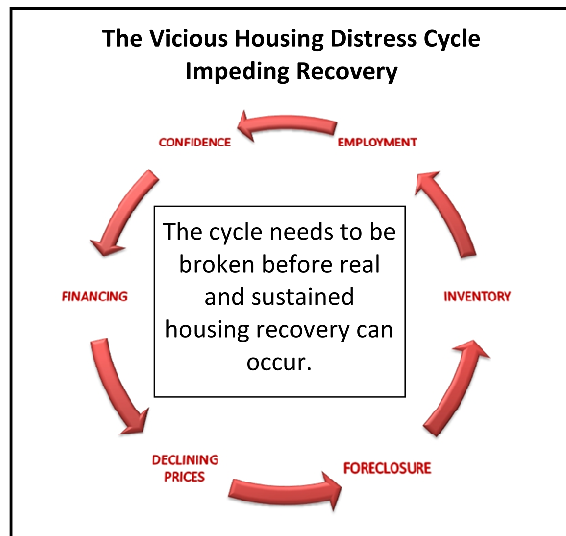
The arguments for and against a bottom are both predictable and as different as night and day. Brokers, builders and lenders are warming up and poised at the starting gate as if waiting for the bell. Consumers aren't so sure and many, but surely not all, economists are doubtful. Yale University Professor and Economist, Robert Shiller, who is also co-creator of the Case-Shiller Home Price Indices, which bear his name recently commented that the U.S. could face a Japanese-style housing slump that could last for years. "*I'm worried that home prices have been declining now for about five years. There's a lot of downward momentum with year over year and even month over month declines.*" Economist Gary Shilling added in the Wall Street Journal that house prices could still decline by 20% or more. He offered that it would take another 22% decline to return median home prices to the trend identified by Robert Shiller which stretched back to 1890 and which prevailed until last decade's housing bubble. Shilling points out that the problem is inventory driven and it will likely take four years to work off the excess, during which time home price growth will be constrained.

The Vicious Housing Distress Cycle Impeding Recovery



The housing market faces some remarkably strong headwinds in the form of foreclosures, shadow inventory, diminished home equity, employment, stagnating wages, financing availability and more. Although some positive things have happened and while the broader economy has shown modest signs of recovery, the negatives affecting short term housing recovery outweigh the positives.

Consider foreclosures and shadow inventory. While foreclosures were down 17% year over year in March (according to RealtyTrac), they still total nearly 200,000 loans across the nation. Additionally, nearly 65,000 new actions were filed in March. One in every 662 housing units nationally received some sort of foreclosure notice. That ratio is roughly double in Florida (1/336), Georgia (1/361),Arizona (1/300), Nevada (1/301 and elsewhere.

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Much of the contraction in the number of foreclosures over the last year was caused by last year's "robo-signing scandal." Following that, many large banks and servicers were reluctant to move forward with foreclosure filings. Now, however, most have settled with both regulators and State Attorneys General. That will likely mean re-acceleration of foreclosure activity before the rate trends down for good. This is likely to cause home prices to dip modestly through at least the end of this year and constrain prices longer term.

CoreLogic, a leading provider of information and analytics, reported recently that for every two homes offered for sale, there was one in the "shadow." In other words, roughly half the shadow inventory has not yet entered the foreclosure process. By definition, *shadow inventory* means homes in foreclosure or where loans are at least 90 days delinquent. The shadow inventory stands at about 1.6 million units compared to a year earlier when it was 1.8 million. It is also about four times higher than it was at its low point (380,000) which was also the peak of the housing bubble in 2006. Moreover, shadow inventory appears to be concentrated in the states with the largest price decline thus adding more credence to the notion that the leading cause of foreclosure is negative equity. In addition, the shadow is largely comprised of assets in the lower price ranges. As the shadow moves to foreclosure, then on to REO (Real Estate Owned) at banks, there will continue to be downward pressure on prices.

Employment has improved but job growth is still too slow to restore jobs lost during the Great Recession. While the economy has gained 3.745 million jobs since the declared end of the recession in June 2009, the economy still needs another 5.0 million to return to the pre-recession peak.

In April there were 12.9 million Americans unemployed. That is 8.1% of the labor force and the economy created only 115,000 new payroll jobs. While the nation's unemployment rate has hovered above eight-percent for 39 consecutive months, recent *declines* in the unemployment rate have not been the product of significantly more jobs but rather a contracting labor force. Indeed, more workers have simply dropped out. Some have retired. Others have become discouraged and have just given up looking for employment. Indeed, the labor force participation rate has dropped to 63.6% (April 2012) which is the lowest since 1981.

Looking behind the numbers, some 5.1 million of the total 12.9 million unemployed or 41.3%, have been unemployed long term. By Bureau of Labor Statistics definition that is 27 weeks or longer. An additional 7.9 million workers were employed part time for economic reasons meaning they would prefer to work full time but could not find full time employment. Still another 2.4 million workers were "marginally attached" to the work force and 968,000 were discouraged and had given up. All that brings the underemployment rate (BLS alternative measure U-6) to 14.5%.

In addition to unemployment, there is evidence that wages are stagnating. In a study by Pew Research, it was revealed that workers who lost a job between 2007 and 2009 and who subsequently became re-employed, earned, on average 20% less than they did at the job they lost. Additionally, a large share of the jobs being created currently are lower pay.

During previous recessions, including the 10 since World War II (not including the most recent) most unemployment was cyclical and workers were called back to the same or similar jobs. Today's unemployment is more structural in that more losses are permanent and won't come back. Technology has been chipping away at employment for several decades and the need for retraining is perhaps greater than ever.

Finally, the nation's unemployment rate has averaged 5.7% for nearly 64 years. Looking forward, we can expect the average rate to be higher, perhaps in the 6.5% to 7.5% range due largely to structural changes and the lasting impact of technology.

Employment, including a lingering higher average unemployment rate, stagnating wages, longer term unemployment, uncertainty and other structural changes will continue to weigh heavily on housing. After all, the unemployed or underemployed and those with stagnating wages can't or won't buy or they buy less.

Diminished home equity is an issue that has received comparatively little attention since the housing bust but one that will weigh heavily long term. Intuitively, one might expect that as house prices rose, so would equity. Instead the opposite occurred as consumers withdrew equity on a regular basis to make other purchases. In 2006 for example, homeowners extracted $500 Billion of home equity; an amount equal to roughly 3.8% of GDP. The collapse in home prices which began in 2007 destroyed much of the remaining equity. Since equity was extracted for new home purchases, investment, entrepreneurial endeavors, education and financing or refinancing small business, the ultimate effect of diminished equity is likely to impede economic growth over at least the next decade.

Diminished home equity will weigh on housing and the broader economy in numerous ways. It will constrain move up buyers, lead to an absence of mobility to accept better job opportunities, lead to an inability to fund small business and even lead to an inability to obtain higher education thus possibly constraining wages for the next generation of consumers.

Conclusions. The implicit assumption that reaching a definitive housing bottom will result in a new round of rising home prices is wrong. A definitive bottom may, however, enhance potential home buyer confidence. What happens next is the more important story.

Foreclosures and the shadow inventory will continue to keep a lid on home prices for several years as the market works through the excess of distressed inventory. That is likely a two to four year process. Employment too will constrain home purchases as a result of a new normal in unemployment, stagnating wages or slow wage growth and a reduced rate of household formation. Reduced home equity will constrain move up buyers and limit other buyers ability to relocate and perhaps accept better employment.

In our view, the housing market has hit a bottom in the broad sense that the free fall in prices is over; barring, of course, some currently unforeseen economic shock. Nevertheless, it will still be several years before we see a full, self sustaining recovery and a robust market. Prices are still likely to fluctuate, both up and down, within a fairly narrow range of two to five percent for at least the next 18 months. Price growth will remain generally flat with no truly discernible and predictable upward movement.

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