The Current Housing Market

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Housing Market – a unique situation in history

In the 45 years prior to 1995, house prices (adjusted for inflation) barely rose at all. From the late '90s and for about 10 years after that, house prices nationally rose by 70% more than inflation.

Consequently, an estimated $8 Trillion in "bubble wealth" was created.

This brings to a critical caveat for real estate investors:

Housing markets tend to adjust very gradually, and price declines have historically averaged 18 quarters in duration.

The Foreclosure Problem

The foreclosure problem started with the collapse of subprime. Unfortunately the end is still not in sight. Subprime resets peaked in 2008; but "Pay Option ARM" and "Alt-A" loan problems will not peak until 2011.

Real estate experts see another new wave of foreclosures coming up in the next year with FHA loans gone bad (mortgage lenders have been trying to push FHA loans in the last 2 years to marginal credit buyer) and higher end homes. Homeowners with savings and investments were able to hold on to their homes longer, even with adjustable rate loans, but with economy still in trouble and money tight, a wave of higher end homes in foreclosure has already started to hit the market and it is going to get worse.

The Hard Truth

The core problem is "house-crazed" buyers borrowed too much money over the past decade, buying into an every increasing price bubble, that had absolutely no basis in "utility value."

Predatory mortgage lending worsened the present situation, but the bottom line is that too many people bought too much house.

Since the housing market went completely insane in 2002, home prices in many areas are still seriously disconnected from fundamentals far beyond any historically known relationship to either rents or salaries.

Never before in our history has it been so cheap to rent relative to own. Rents are as low as 40% or 50% of monthly mortgage costs (vs. historical 10-year average of 92% rent-to-mortgage ratios) in various parts of the country; and yearly rents are as low as 3% of purchase price.

The harsh reality is that salaries cannot cover mortgages at existing prices, especially with many recent salary cuts, job losses and redistribution of wealth.

In some areas 50% to 60% price declines are considered very possible! We are seeing builder discounts in many areas of 30% or more on the same models as last year, not including increased concessions. Condos are down 40% or more at auctions. Prime buildable lots have dropped as much as 60%!

To put these price declines into perspective, both the S&P/Case-Shiller U.S. National Home Price Index and the OFHEO, Purchase Only, SA index show that a 15% nominal price decline would roll prices back to late 2004, for both indices.

At a 30% price decline, Case-Shiller moves prices back to mid-2003, and OFHEO, 30% drops prices to late 2002. And a 50% decline would carve home prices all the way back to 1997 levels!

Not all areas will see the same price declines of course, but these indices provide a gross estimate of the number of homeowners with no equity, based on price decline assumptions.

At the end of 2006, there were approximately 3.5 million U.S. homeowners with no equity or negative equity (7% of the 51 million household with mortgages). By the end of 2007, the number had risen to about 5.6 million. In 2008 many areas have seen an additional prices drop of 10%, and the number of homeowners with no equity has risen to 10.7 million.

Updated Figures and Trends as of September 2010

Mortgage rates have continued to drop, home prices have increased, the number of borrowers 60 days or more delinquent on their mortgage payments has decreased, mortgage applications for home purchases have risen, that's about where the good news ends. New and existing home sales fell, inventories of unsold homes have risen, construction spending has dropped, new foreclosure initiations have increased, the number of newly distressed loans has increased and the progress of the Obama administrations HAMP program slowed.

Mortgage rates have continued to set record lows. The 30 year fixed rate mortgage averaged 4.32% for the week ending September 2nd, according to Freddie Mac. That is the lowest on record since Freddie Mac began tracking mortgage rates in 1971. That makes it now 11 weeks where the mortgage also hit a record low with an average posted by Freddie Mac at 3.83%

Borrower delinquency figures from the Mortgage Bankers Association that reflect data from July show that delinquency rates where borrowers missed at least one payment or were in foreclosure were at 14.4% of all borrowers in July. That's a decrease of 0.3% from June's data, reflecting a 14.7% delinquency rate for the nation's borrowers. The drop was represented by the decreased in the number of borrowers that were 60 days or more delinquent. However, the number of newly distressed borrowers increased for the month of July.

As a result of the record low interest rates, mortgage applications saw a brief increase of 1% for the third week of August.

The sale of existing homes during the month of July fell 27.2% from June, according to the National Association of Realtors. That increased the supply to 9.1 months and is the lowest sales data recorded since tracking started in 1963.

Spending on construction for the month of July fell 1% from June. That drops the seasonally adjusted annual spending rate to $805.2 billion for July.

The Obama administration's HAMP program, which was supposed to help nearly 4 million struggling borrowers with mortgage modifications has not lived up to expectations. HAMP had a rough July with more cancellations than new trial modifications. According to the Treasury Department, roughly 17,000 borrowers received new trial modifications and nearly five times that (96,025) had their temporary modifications cancelled.

Think like a Real Estate Investor

To paraphrase from a quiz that uberinvestor Warren Buffett presented to Berkshire-Hathaway shareholders at their annual meeting in 1998,

"When you are buying hamburgers, would you prefer that the price of hamburgers is going up or going down? Likewise, if you expect to be a net saver during the next five years, should you hope for a higher or lower [real estate] market during that period?

"Many investors get this one wrong. Even though they are going to be net buyers of [real estate] for many years to come, they are elated when [real estate] prices rise and depressed when they fall.

"In effect, they rejoice because prices have risen for the 'hamburgers' they will soon be buying? This reaction makes no sense. Only those who will be sellers [of properties] in the near future should be happy at seeing [real estate prices] rise. Prospective purchasers should much prefer sinking prices."

These present times, as painful as they are, will prove to be an epochal time of wealth building, if we position ourselves correctly.

Creative real estate investors need a new way of looking at the marketplace.

This will require the ability to ignore the hyperbole of the marketplace generated by builders, real estate agents, mortgage lenders, and unscrupulous appraisers and maintaining an intense focus on the economic factors specific to *that* community.

Toss out the concept of "fair market value" for the most part, and focus on "economic value" based on "affordability."

The rules of the game have changed, but the purpose is to the same end – in real estate risk versus reward is a known component, but you have to add different variables into the mix: you'll need to consider household income, population density, interest rates, current and former house prices, and historical data, to determine what house prices *should be*. Adding "rent costs" vs. "owning costs" metrics to the mix is a sound strategy as well.