

It's a National Housing Market

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By now people are aware that prices and sales are falling in housing markets across the U.S. For most markets, sales peaked in the summer of 2005 and prices peaked soon after that. For Humboldt County, sales volume peaked in July 2005 with seasonally adjusted sales today less than three quarters of those amounts. Prices peaked in March 2006 with today's inflation-adjusted price off about 13 percent. Fourteen of the last 15 months have experienced year-over-year real price declines in the median price of a house sold, and the 13 straight months of depreciating house prices is the longest stretch in our data that go back to 1989. Foreclosures in the county increased by 235 percent over the last year.

These numbers mirror what has happened in the rest of California and in other markets. In the past, it was common to say that there is no national housing market, only many local markets. But that doesn't seem to be the case this time. What is remarkable is the degree to which prices in New York, Florida, Las Vegas, Phoenix, and California have moved together. For much of the U.S., intense price appreciation happened without any significant local change to the market. For Humboldt County, prices rose without any large increase in income, without any large increase in rents, and without any large inflow of people (a recent California Department of Finance report shows that we have the fourth highest rate of out-migration of all counties in the state). This lack of local explanations can only point to a national explanation for the housing price increases of recent years. It seems that, for the first time, we now have a national market for housing.

What was that national explanation that caused prices to soar? New mortgages that allowed people to buy houses that they couldn't afford (either their first house, or a later upgrade). The "enabler" in this national credit binge was Wall Street, which paid high prices for mortgage loans and mortgage backed securities. Lenders knew that they could pass along questionable loans to Wall Street and there was no natural check on the availability of credit. Loan amounts soared and as a direct result, housing prices soared. And affordability plummeted.

This summer, Wall Street wised up, and now does not want these mortgages. As a result, many mortgage companies have been forced to buy back the loans which has led to dozens of them going out of business. Today, we may have a credit crunch, which means that credit is not available to people at the going interest rate. If you have stellar credit, then you can continue to borrow (and at a lower rate). But if your credit is less than perfect, if you can't document your income, if you are trying to borrow a large amount, and if you are putting very little money down, then it has just become much, much more difficult to get a mortgage loan.

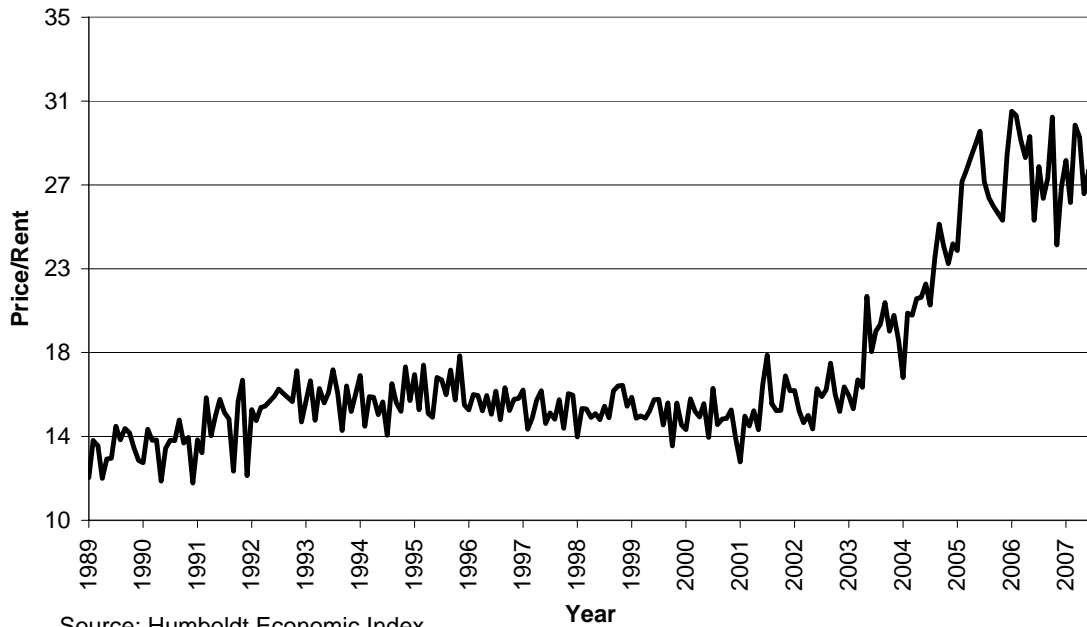
Now that Wall Street will not buy all but the safest mortgages, demand for housing has fallen tremendously. As anyone who has taken an economics course knows when demand falls then the price and quantity sold must fall. We've already seen large drops in both, and more is on the way. Existing house prices fell by 2 percent and sales are down 3.8 percent in August compared to July. New house prices and sales each fell by over 8 percent in the same month.

The question that everyone wants to have answered is "how low will prices go?" Thinking about this is a bit tricky, since we are very much in uncharted waters. The last time we had a period of significant nationwide drops in house prices was The Great Depression. One recent prediction was put out by Moody's Economy.com. They predicted a nationwide drop of 7.7 percent from the peak in 2006 to a bottom in 2008. But that national average includes big forecasted price reductions in areas surrounding Humboldt County, including a 19 percent drop in Sacramento, a 22 percent drop in Reno and Modesto, and a 25 percent drop in Stockton. These are very large numbers. But they are supported by the Case-Shiller housing futures, which reflect the collective wisdom of people who are actually putting money on contracts that are payable five years from now. The nearest large city to us is San Francisco, and for this city investors are predicting 28 percent lower housing prices in five years.

So what will happen in Humboldt County? We are too small a market to attract the attention of professionals who make predictions. But we can turn to a simple measure to ask "how far must prices fall to return to historic and sustainable levels?" That measure is the price to rent ratio, which is very similar to the price to earnings ratio used when analyzing stocks. The house price to rent ratio compares the median price with the average rent, after controlling for expenses. This ratio was very consistent over the last housing boom and bust cycle and averaged 15.4 from 1989 to 2002. But as the figure below shows, the housing price to rent ratio skyrocketed starting in 2002. It peaked over 30, and today is in the upper twenties.

In order for the price to rent ratio to return to historic levels, prices of houses in Humboldt County must fall by 40% from today's values. That means the current median house price of \$316,000 must fall to \$185,000 if rents remain at their current levels. Of course, if rents rise, then housing prices don't need to fall as much in order to return the price to rent ratio to historic levels. But I just don't believe that rents will rise all that much in the future in Humboldt County. In general, rents rise when population and income rises, and neither is rising very quickly. A drop in prices of 40 percent shocked me at first, but then I listened to an interview by Nouriel Roubini of the Stern School of Business and he floated the idea of a 50 percent drop in prices nationally. Some of you might be thinking that this is absurd and that prices will never drop by 40% in Humboldt County. But keep in mind that it seems equally absurd for after inflation prices to double in less than four years, which they did. If prices grew after 2002 at the same rate that prices grew in the previous decade, then today's median price would be \$220,000, or 30 percent less than today's prices.

**Humboldt County Housing Price to Rent Ratio, 1989-2007
(medium home price/mean rent, adjusted for expenses)**



Of course, the forty percent haircut in prices is in inflation-adjusted terms. That means that a long period of flat prices, accompanied by rents rising at the rate of inflation, can accomplish the same result. For example, if prices are unchanged for ten years and there is 4 percent inflation each year, then inflation-adjusted prices will fall by about 40 percent. So at the extremes, we have a decade of unchanging prices or a quick 40 percent adjustment as two ways to get the price to rent ratio to historic levels. The actual path taken by the housing market will probably be somewhere in between. And much will depend on how mortgage credit changes in the long term. If Wall Street resumes its appetite for toxic mortgages, then demand for housing will be buoyed somewhat. A large government bailout of lenders and borrowers will have a similar effect. But if traditional mortgage lending practices return, then housing prices will return to traditional levels.