The Affordable Mortgage Depression

Government policies were designed to increase homeownership. Affordable Mortgages, created to realize this goal, were responsible for the Housing Bubble and distorted the economy. The unwinding of these distortions will result in a Global Depression.

The Most Interesting Housing Event Since Prices Began to Decline in 2006

The Case-Shiller data for May, released on July 28th, encapsulates a fascinating economic event as national housing prices rose month-to-month for the first time since the Summer of 2006. Nationally the 20-City Index rose by 0.5%.

Many newspapers and prominent economists will report the data as a definitive end to the housing recession. There is no doubt that if housing prices have stabilized, it would be an extraordinarily positive event for the economy as homeowner equity is no longer being eroded on a leveraged basis.

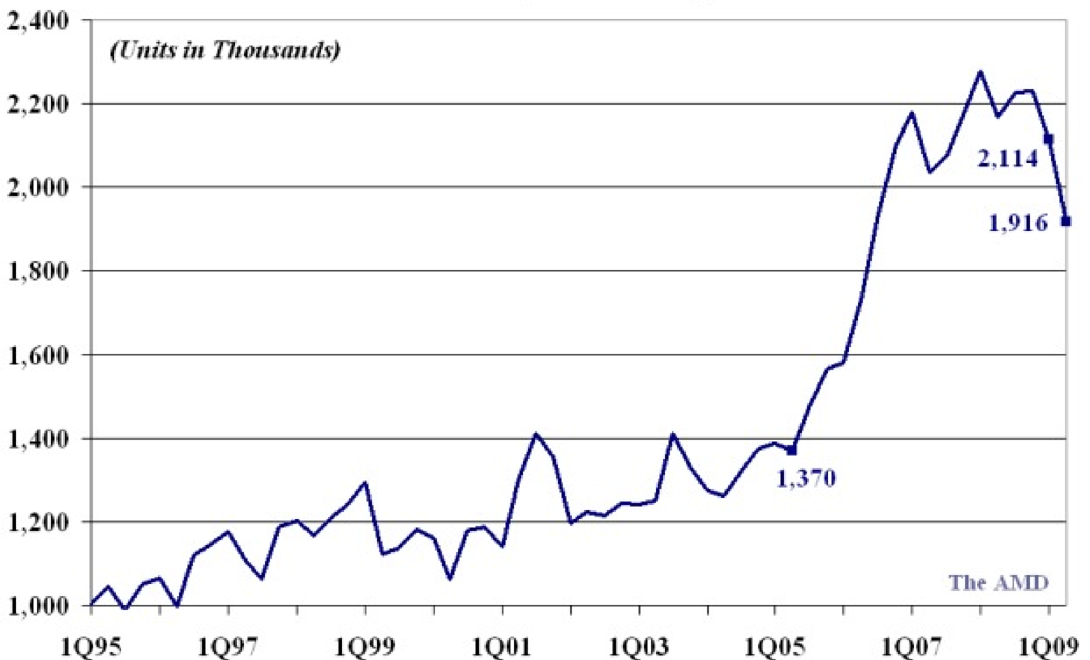
The important question becomes "why did national housing prices rise in May"? Have prices reached a sustainable equilibrium relative to economic fundamentals and the new financing reality?

Analyzing the Housing Market

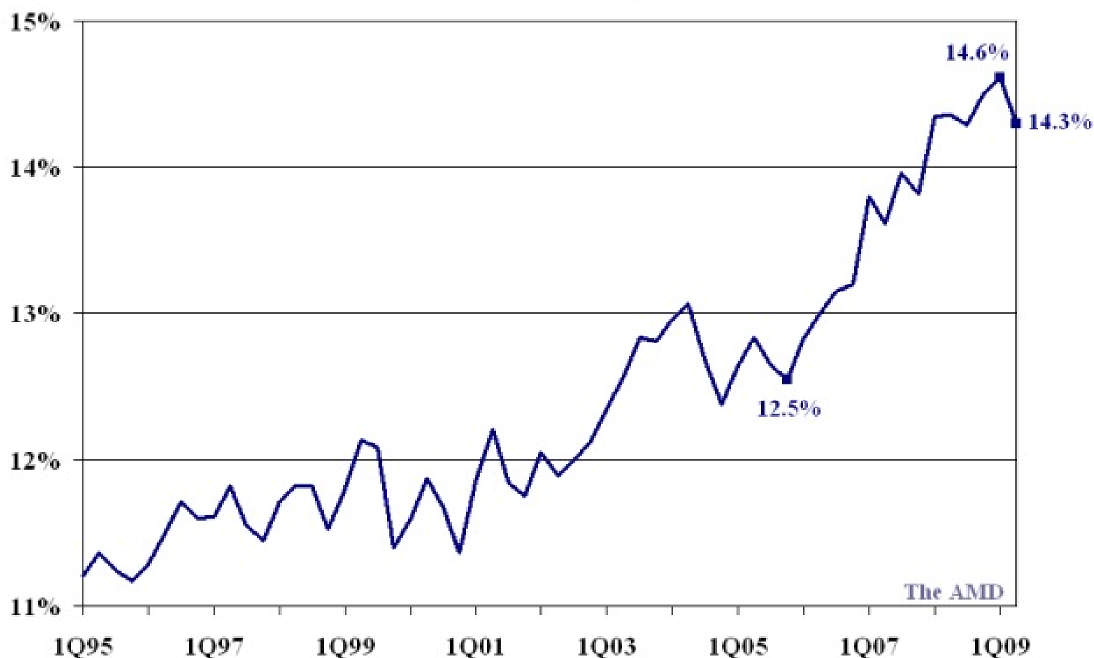
If the Case-Shiller Index gain was driven by improving conditions within the economy it would bode well for the stabilization of home prices.

Excluding the financing environment, important housing market fundamentals which dictate the sustainability of prices include:

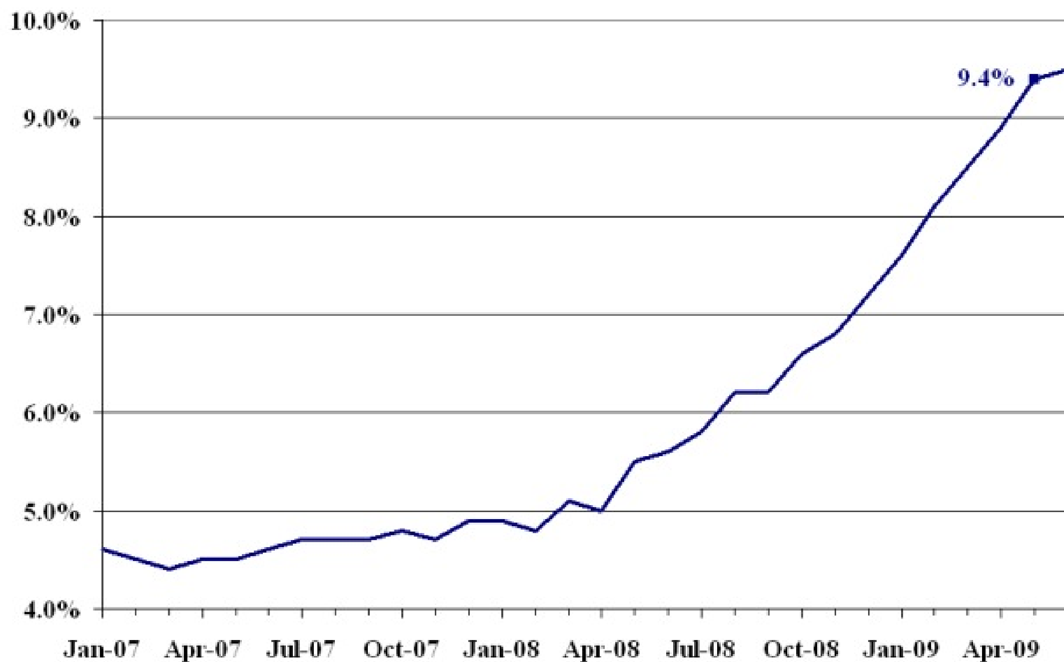
- Inventories of unsold homes
- Vacant houses as a percentage of total housing units
- The unemployment rate
- The number of foreclosures in the market

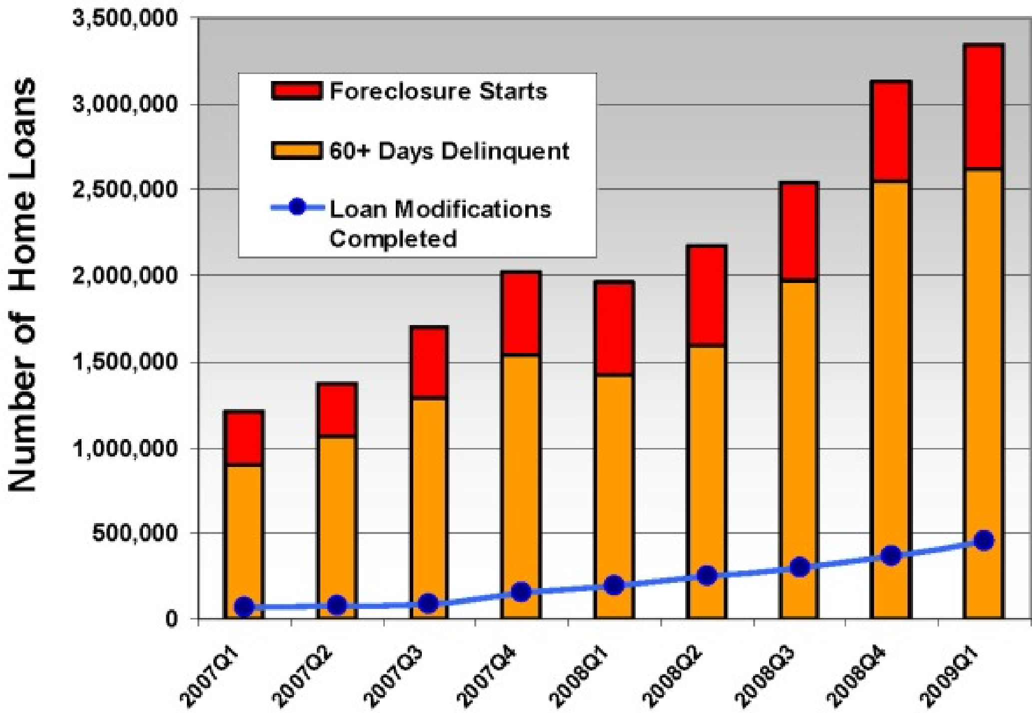


Percentage of All Housing Units Vacant



The Unemployment Rate - High and Rising





(Source: Center for Responsible Lending)

None of these underlying housing market fundamentals have improved to an extent that price stabilization should have resulted.

An Analysis of the Case-Shiller Data

The Case-Shiller May data includes an abundance of information useful in identifying the cause of the price increase.

Housing is all… national???

The obvious observation is that housing prices rose nationally and reversed course in dramatic fashion. In fact, 14 of the 20 cities in the index increased in value. While the layman may regard this broad-based recovery as a positive sign, in reality it does not bode well for a sustainable recovery.

If markets were organically reaching an equilibrium price level relative to economic fundamentals, the inflection point would not have been dramatic or national. Markets would have stabilized as they approached sustainable values. Cities would act differently from one another based on their individual economic circumstances and specific housing price levels.

I note that the city indexes began their decline over a rolling period of time. Of the 20 cities, index values peaked in 11 different months over two years ranging from November 2005 (San Diego) to August 2007 (Charlotte). It is fascinating that individual index values reached their zenith independently, but that the same Case-Shiller markets suddenly reversed course this year in a highly correlated fashion (15% were up in March, 40% in April, 70% in May). I note that San Diego and Charlotte, the two outliers, were amongst the May performers.

What the data is clearly showing is that something dramatic and national in scope caused the reversal in house prices.

The Motor City

Detroit is an interesting case. Based on local economic fundamentals the city has been the worst performing market in the Case-Shiller index for the past decade. During the month of May Detroit posted a modest index gain of 0.2%.

A fascinating set of coincidences puts this performance into context. On April 30th (the day before May)

Chrysler filed for bankruptcy and on June 1st (the day after May) GM filed its long anticipated bankruptcy. Does this not seem strange? Potentially the most devastating economic events in Detroit's history, which will result in higher unemployment and a lower income and tax base, produced rising housing prices.

These events which bracketed the month of May further reinforce the idea that the national index performance had nothing to do with local economic fundamentals or sustainable housing valuations.

Viva Las Vegas

Las Vegas was the worst performer in May down 2.6%. Given that the market has already declined 53.4% from its peak, Las Vegas might have been a good candidate for bottoming. It appears that Las Vegas' woes, magnified by its tourist-centric economy, were enough to overcome the forces which stabilized the rest of the country.

The Big Apple

New York's index value stabilized with a 0% change during May. Given the disastrous impact of the economic crisis on the local economy and its status as the most overvalued housing market in the U.S. (down only 21% from the peak), New York seems the least likely market in America to have recovered (regardless of looming Goldman Sachs bonuses).

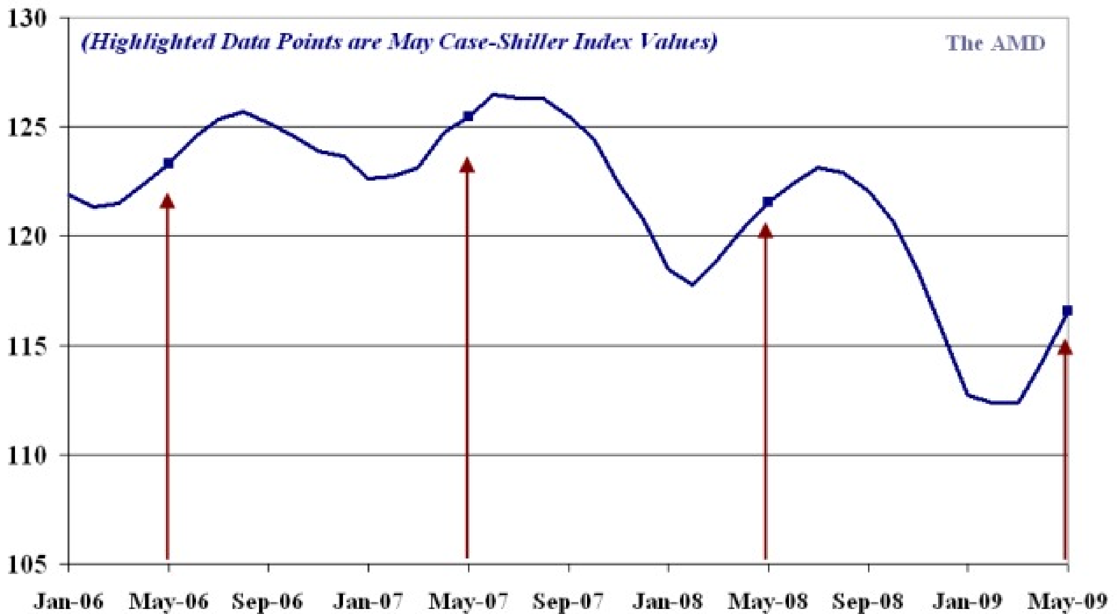
According the Case-Shiller data, some combination of non-fundamental forces caused a dramatic and nationwide reversal of price declines.

What Combination of Factors Stabilized Housing Prices?

The question remains why did national housing prices, which have been declining for 3 years, suddenly reverse course in defiance of eroding economic fundamentals.

Seasonality Was a Contributing Factor

The Housing Market is seasonal. Boom or Bust this continues to be the case. As demonstrated below, housing sales pick up in Spring and early Summer and result in seasonal price appreciation. I have used the Dallas market as a proxy to demonstrate the phenomenon because, of the 20 Case-Shiller cities, Texas was the least effected by The Bubble and The Bust.



Price pressure from The Buying Season was certainly a contributing factor.

The Real Culprit: Government Manipulation

It is within the Federal Government's power to distort economic activity through direct intervention in markets. In fact, this is how The Housing Bubble was created.

The Government can:

- Increase car sales by paying people $4,500 to buy autos through a "Cash for Clunkers Program"
- Squash deflation by printing money as was recently accomplished by the Federal Reserve
- Manipulate GDP and unemployment through deficit-financed Stimulus Spending and $2 trillion annual budget deficits

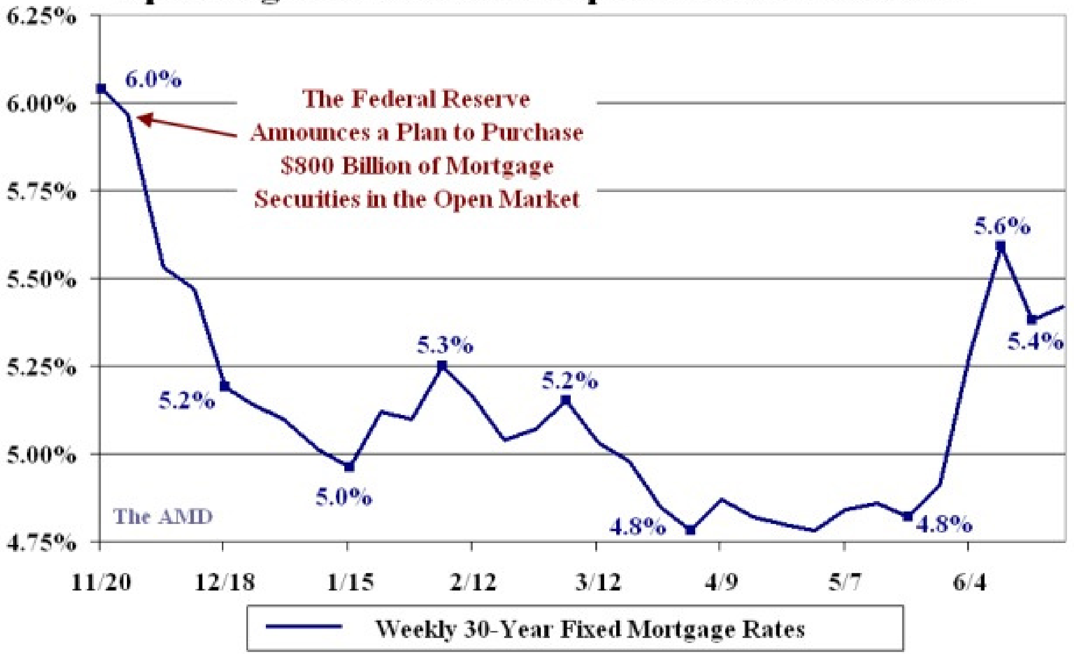
But these manipulations not free, and while the short-term, visible outcomes may be perceived as beneficial, the costs and inevitable results of the programs must be accounted.

The benefits of deficit spending are temporary, while debt remains, must be serviced and repaid. Massive increases in the money supply may stimulate the economy, but create the dilemma of a choice between having to strangle the recovery or enduring hyper-inflation. Furthermore, Government-created economic distortions are unsustainable.

The Housing Price Distortions at Work in May

Manipulating Mortgage Rates
In November of 2008 the Federal Reserve began overtly manipulating mortgage rates through open-market purchases of mortgage securities. The Fed spent $800 billion to lower fixed interest rates to the historic low of 4.8% in May of this year.

The lowest mortgage rates in U.S. history contributed to an increase in home purchases. The problem with this "solution" is that it cost $800 billion and is not sustainable. In fact, interest rates have already risen back to December 2008 levels approximating 5.5%. This particular Government housing distortion has already run its course but was operating at maximum effect in May.

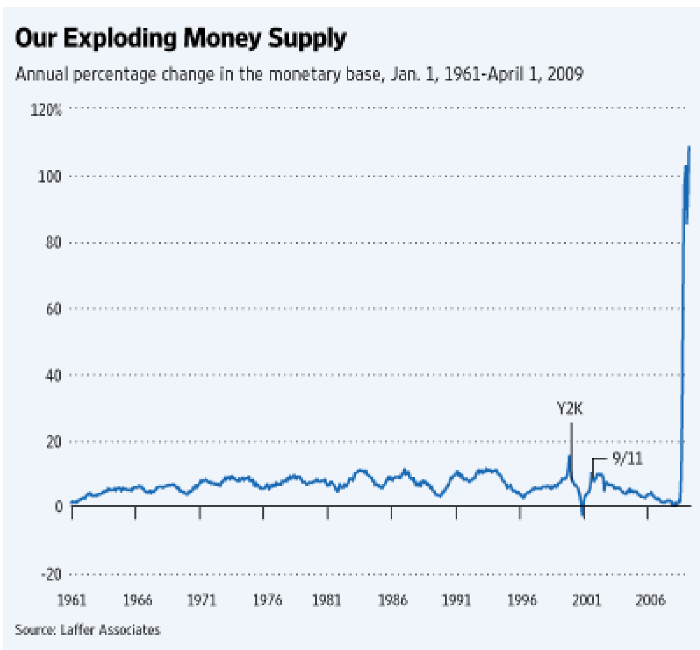


Expanding Money Supply

Starting in late 2008 the Federal Reserve increased the money supply by almost a trillion dollars. Most of this newly created currency found itself into bank reserves (a 19-fold increase from existing levels). Banks are able to make loans up to specifically-defined bank reserve ratios. The higher the reserves, the more banks can lend.

The largest increase in bank lending capacity in history certainly contributed to the improved availability of mortgages.

But the massive increase in money supply and bank lending capacity creates the likelihood of inflation when the economy stabilizes. Should money supply be reduced, as it must eventually, this distortive force will disappear and housing prices will again be determined by market conditions.



Mortgages with Dangerously Low Down Payments

The Government has transformed the FHA and other GSEs into the World's largest predatory lenders. These institutions are now handing out mortgages with down payments as low as 3%.

Access to Government subsidized mortgages with minimal purchase hurdles certainly contributed to the stabilization of housing prices in May.

But down payments exist for a reason. They act as a restraint to house purchases and in doing so regulate prices relative to economic fundamentals. Down payments stabilize the housing market and prevent foreclosures (and self-reinforcing foreclosure spirals) during times of economic distress.

By issuing mortgages with leverage ratios of 32:1 (a level which would make a hedge fund blush), the Government is financing the purchase of homes by people who can not afford to buy them and, in doing so, is increasing housing market risk in exchange for the perception of short term stability.

Just like Fannie Mae and Freddie Mac during the Housing Bubble, the Government's activities will result in financial ruin paid for by tax payers, rising deficits and at the risk of national insolvency.

Paying People to Buy Houses
The Stimulus Spending Bill, passed in February, included a provision for an $8,000 tax credit for new homebuyers. Paying people to buy things is an effective way to distort consumption behavior. This tax incentive has succeeded in increasing home purchases.

But the behavior is predicated on the distortive incentive. What happens when the bribe disappears? Prices will still be above equilibrium relative to fundamentals.

Foreclosure Moratoriums and Loan Modification
The Government has applied direct and indirect pressure on lenders to forestall foreclosures, as well as financing its own loan mitigation efforts. These initiatives produce the short-term, perceived benefit of reduced foreclosures. But they also delay the inevitable, prevent vital market-clearing transactions, and impede a resolution to the economic crisis.

Foreclosure prevention efforts, combined with a seasonal increase in purchases and buying activity motivated by subsidized interest rates, low-down payments and an $8,000 tax credit has temporarily halted the decline in housing prices.

Dismal Reality

The indignation which prompted the creation of this web-site was an initiative proposed by the Dean of the Columbia Business School in the Wall Street Journal on October 2nd, 2008. The proposal urged the Government to refinance all of the nation's mortgages at a 5.25% rate as the solution to the housing and economic crisis. My conclusion was that such efforts to prop up housing prices would ultimately fail and only worsen the depression.

Sadly, the Government subscribed to this ideology by lowing mortgage rates to 4.8% and subsidizing home purchases in a variety of ways. I believe that policy makers have succeeded in temporarily propping up housing prices at unsustainable levels. But these prices will only remain over-valued as long as the Government is willing and able to subsidize them.

If housing prices had stabilized for fundamental reasons, I would happily declare the Housing Recession and Affordable Mortgage Depression to be over. But without extraordinary Government intervention, housing prices would have fallen in May and in doing so would have continued to accomplish what is necessary to resolve the downturn. Instead, the Government has manipulated the markets and distorted prices using the same twisted logic that created the Housing Bubble. Our politicians have only succeeded in prolonging and deepening the economic depression.

When these unsustainable manipulations run their course or economic fundamentals again overwhelm them, housing prices will continue to fall towards a sustainable equilibrium relative to the determinants of value.

Posted by Whitney Ross at 7/29/2009 1:24 PM
Categories: Focus on Home Prices,Housing Stabilization Proposals,Economic Analysis,There Is No

Comments

Display comments as (Linear | Threaded)

Rick Warwick wrote: *7/31/2009 9:05 AM*

You are right on the button and very clear and concise in how you have laid out the truth.

The markets are moving higher now, knowing full well that a new collapse is coming.

Great Report ...!!!

Reply to this

L Rivera wrote: *7/31/2009 1:25 PM*

I was wondering how was it possible for houses to increase in price and sales, when so many areas in the economy are still suffering and even worsening. Now I understand what happened: just more government-sponsored Kool-aid. Thank you for this post.

Reply to this

backwardsevolution wrote: *7/31/2009 6:24 PM*

What a brilliant report! Now it all makes sense. The government continues to artificially prop up the price of houses. There is no way you should be able to buy a house with only 3% down; you need more skin in the game than that. Moratoriums on foreclosures? Isn't that a sweet effort to keep the price of houses up! Limit supply, drive the price up.

Unbelievable and disgusting! Thank you for all your hard work.

Reply to this

pinky wrote: *7/31/2009 7:08 PM*

Your dead on, at this point we should just let things play out. Losing another 10% is better than all the spending we have to do to prop the market.

I wonder what would have happened if they did nothing.

Reply to this

Bullfinch wrote: *8/1/2009 5:00 AM*

Would people quit with the idea that Texas was not part of the bubble? It was behind the bubble! It started here in about late '04 according to the flowcharts, where you suddenly see a conspicuously meteoric rise in home prices between then and now.

Reply to this

> Whitney Ross wrote: *8/1/2009 12:20 PM*
>
> Bullfinch,

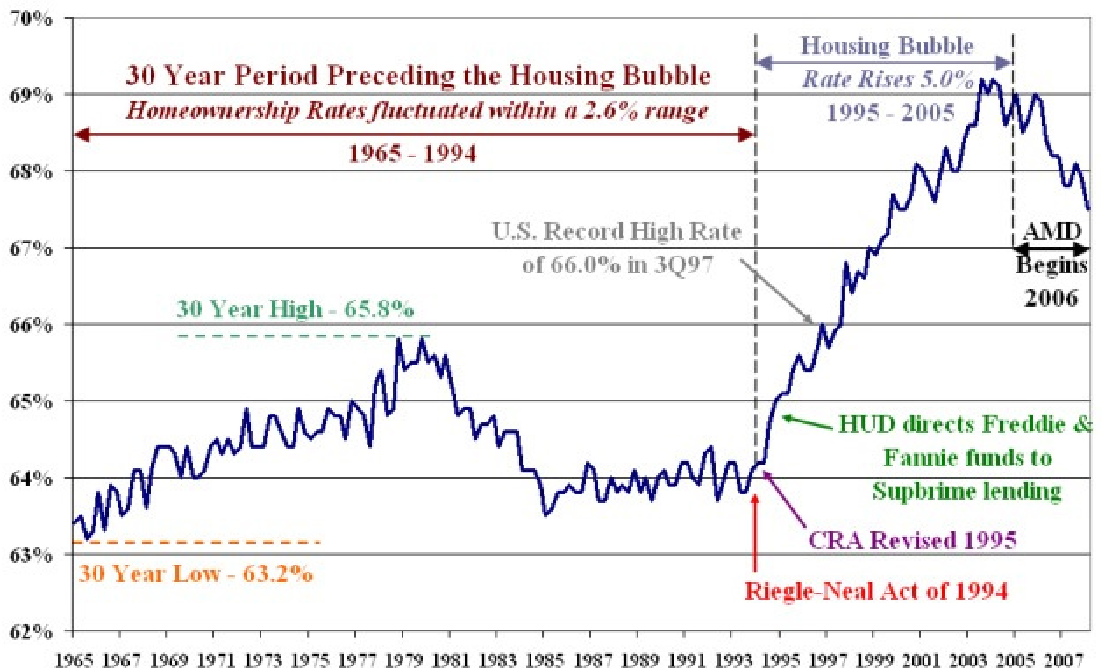
Thanks for reading. Should you be in possession of information that proves your assertions (the "flow chart" you mention), I would very much like to review it.

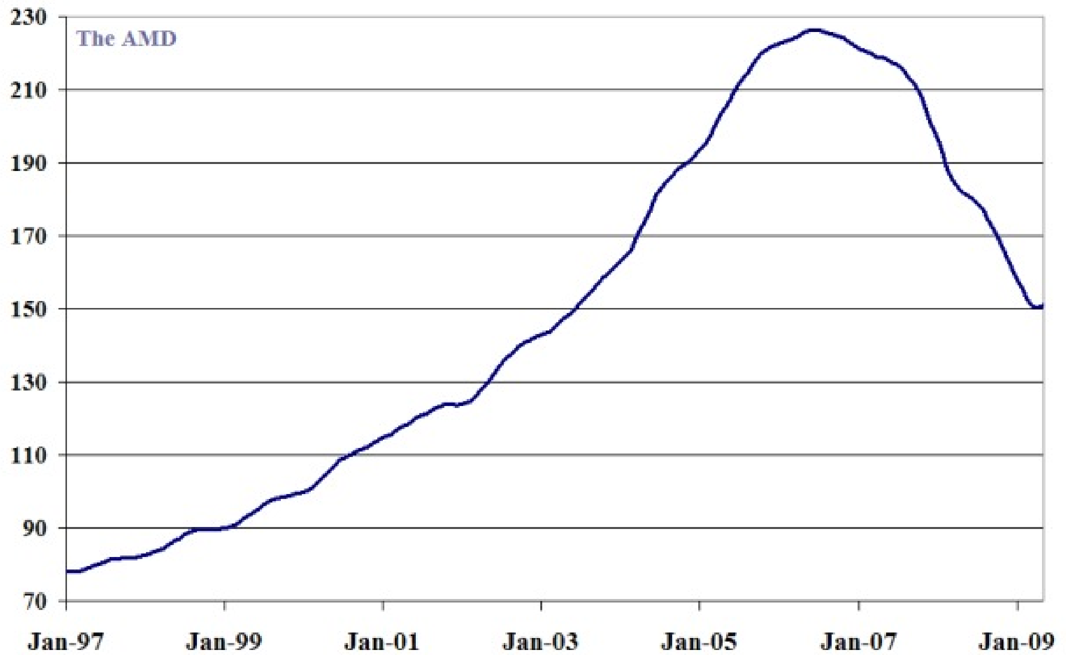
But based on all available information, your argument is nonsensical. Historical data clearly demonstrates that the Housing Bubble began in 1995 when homeownership exploded in record fashion. (see chart below). Housing prices responded to the homeownership bubble by rising nationally at an unsustainable and accelerating pace beginning in 1997. (see second chart below)

As such, your assertion that the Housing Bubble began in 2004 is absurd. Equally as strange is your statement that Texas led the charge. The data demonstrates the opposite. (see third and forth charts below)

Admittedly, I am using Dallas as a proxy for Texas, as I am relying on the Case-Shiller 20-City Index as a proxy for the United States.

I would genuinely appreciate the submission of materials that demonstrates your contention. Should it exist I would happily post it.




Case-Shiller 10-City Index Values Since 1997
The AMD
230
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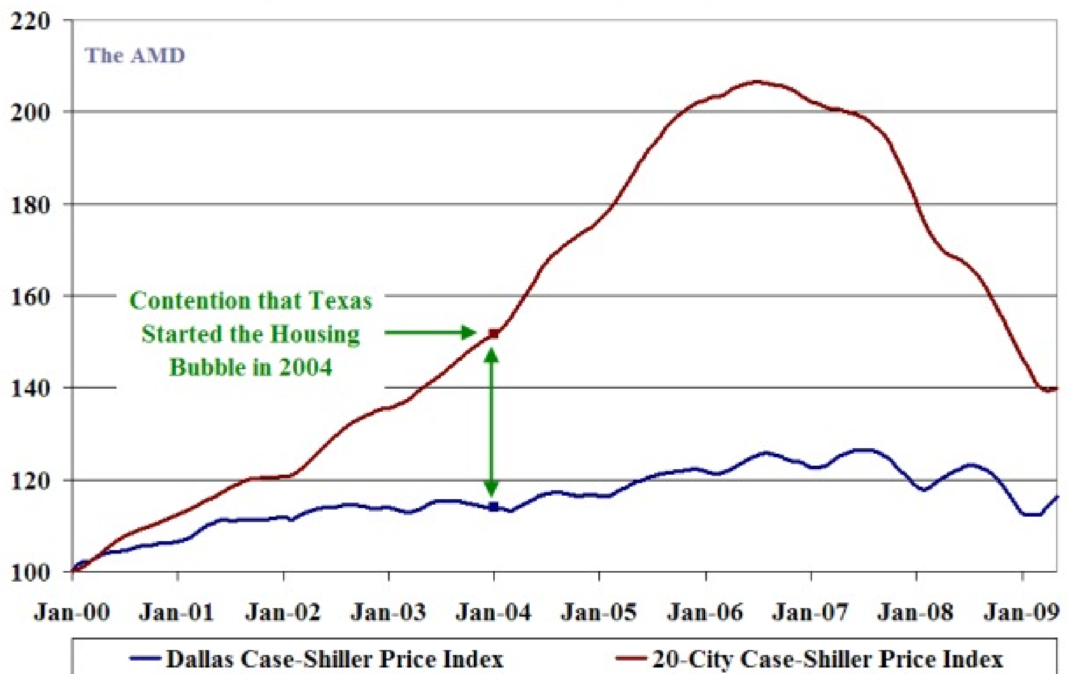
Texas… It's Like a Whole Other Country!
The AMD
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Contention that Texas
Started the Housing
Bubble in 2004
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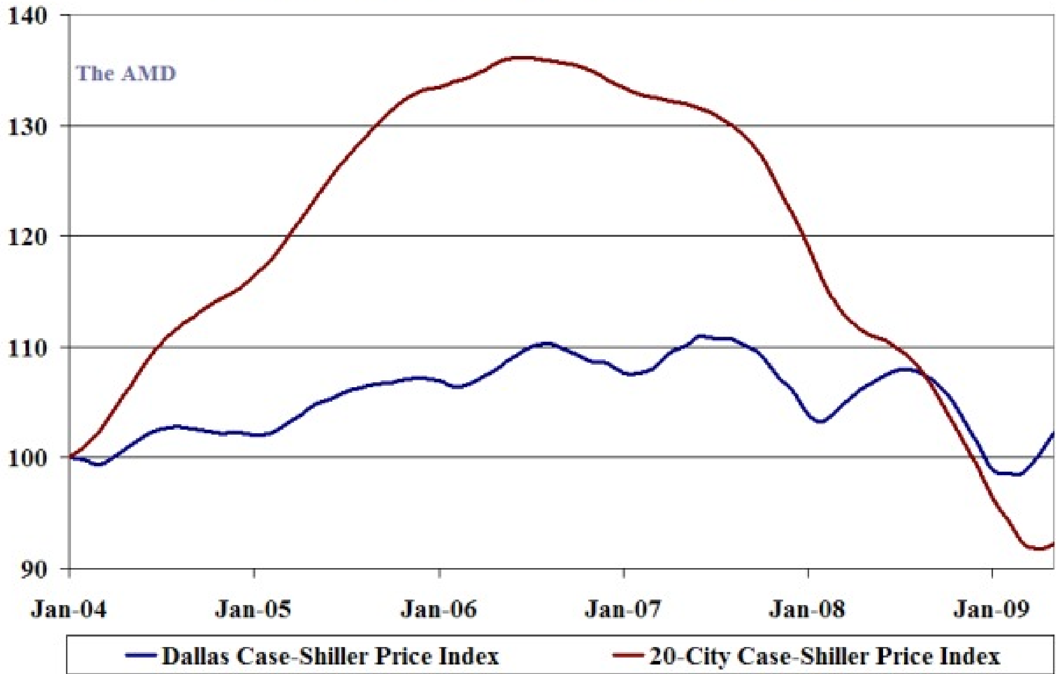
Dallas Case-Shiller Price Index
20-City Case-Shiller Price Index



Reply to this

REinsider wrote: 8/6/2009 10:52 AM

Excellent report! Brings into focus many factors and most notably the effect of government policy on the markets, both in causing the Great Housing Bubble, and the current Mini Bubble.

However much I agree that prices are being influenced by government intervention, I don't agree that home prices will "collapse" after Nov. 1st (or whenever the $8,000 tax credit program eventually stops).

We would be wise to not underestimate the ability of Wall Street and the Banksters to continue the charade.

Just as yesterday the Senate voted to continue Cash for Clunkers, there will be great pressure applied to extend the $8,000 tax credit(they will extend thru Jan 31st or longer).

GS and the Banksters planned this whole easy-credit Housing Bubble "from the very beginning" (Clinton/Rubin/Summers, repeal of Glass-Steagall, Bush/Paulson and Obama/Summers/Geithner). The game they haved rigged and their "next move" is planned several steps ahead.

Suppose the home buyer stimulus package ends soon, and doesn't get reinvented in some modified form. Eventually the majority of these home buyers (that still have jobs) who were priced-out by the Bubble will have "bought". Eventually even THIS stimulus takes its natural course and spends itself out.

What then? Total market collapse? I don't think so. Maybe some softening, maybe some roll-back of the "gains" (10% to 20%) of the past few months. But systemic "collapse". No. Don't think so.

To be clear, when I talk home prices, for this post I mean homes "affordable" to the 80% majority, which are priced in the "bottom" 20%. A distinction if NEVER see Case-Shiller, nor may pundits!

Here in the SF Bay Area, I am referring to homes priced below $495K. In our Central Valley major metros (Sacto-Fresno) homes priced below $250K. In the secondary markets hardest hit by Sub prime (Stockton-Modesto, Merced-Madera, Salinas) those homes priced below $150K)(now well-below the National Median in these areas).

Everyone (Whitney included) seem to have forgotten the huge pool of Boomer investors well-familiarized with RE investment, quite comfortable with RE for asset diversification/preservation, cash flow, and as an inflation hedge. This group of investors represents a HUGE pool of funds itching to get back on the playing field. Waiting for the "right . And there has been no "stimulus" for INVESTORS (other than a 75% decline in prices down to just 100-125 times monthly rents). Not even a level playing field for most investors. By design!

Sure, Fannie raised its conforming "investor" loan limit from four (R1-4 loans total) to ten. But NONE of the big banks raised their investor loan limits to ten. And NONE will make such favorable rate "conforming loans" to LLC's (investment groups). None! Zip! For us to make a true "business" out of acquiring, renovating, renting, and the long-term "hold" within the safety and utility of the proper professional "entity" (LLC) in an reasonable quantity we have to pay "cash".
Reply to this

REinsider wrote: *8/6/2009 11:21 AM*
Whitney, I love that you have a "character counter" for our posts. Unfortunately I couldn't come in under 3000 characters, tried to "edit" it down to finish my point, and decided to "submit" what I had written, and add this post to finish and make my point:

Despite the wishes of the Bears, and the counter-hype of the Bulls I do NOT see any significant "collapse" in home prices within the most-affordable "bottom" 20% of home prices, at least not here in Northern California.

Let me explain:

Despite Case-Shiller's National News-Making Index: REAL ESTATE IS LOCAL (and this fact has hardly ever been more true than it is today!)

Within these NorCal markets cited in my prior post we have seen 60% to 80% declines in prices since the Housing Bubble peak for which our secondary market declines have led the Nation. Remember the 60-Minutes segment on Stockton?

And our primary markets, represent some of the still-strongest job markets in the country (SF, San Jose "Silicon Valley") yet we have already seen 35% to 50% price declines in our "most affordable" bottom 20% in these areas.

This said, since March-April I have seen these "affordable" prices ranges boosted off the price bottoms of Dec-Jan by 10%-20%, which as Whitney so perfectly made the case in this report, is almost entirely due to government intervention (stimulus of various sorts).

The fact that no one mentions, and the case my post is intended to make, is that there has been no "stimulus" (other than today's relatively good pricing, i.e. for investors many opportunities now at 100x to 120x monthly rents, which historically has been the investor-price inflection point).

Therefore, when all the current "first time buyers" buy their homes and get place, OR interest rates rise, affordability drops, and they as well as most of the "owner-occ" market gets priced-out, THEN, and probably only then, will our "policymakers" play one of the cards they have been holding:

Financing for "investors". Financing for "entities" (LLC's). My expectation is this will occur sometime during 2010, probably after next year's summer run-up, as the market slows into the "bottom of the fourth (quarter)".

My HOPE is that our "policymakers" don't' give away the store as they did to stimulate this year's first-time buyer and side-lined buyer driven Mini Housing Bubble. My HOPE is that the Banksters will realize that ALL they have to do is provide an ample source of 6.5% money at 75% LTV. And homes in our NorCal markets, which have ALREADY PRICE-ADJUSTED will fly off the shelf IF they make this money "non-recourse" OR lend to qualified LLC's with no limits as to the "number" of homes per borrower or entity.

THIS is the "Great Back-Stop" card the policymakers are holding against any sort of systemic housing price collapse!

Whitney, love your "Check Spelling" feature too! Wish all the bloggers had this and used it!
Reply to this

Whitney Ross wrote: *8/7/2009 7:58 AM*

REinsider,

Thanks for the thoughtful and detailed analysis. You make excellent observations and propose some dynamic ideas. I am posting it as a free-standing article so that it receives wider attention.

I agree with you that housing prices likely won't collapse. I only argue that they would presently be falling without Government interference due to the following:

• Prices are still above inflation-adjusted pre-bubble prices
• Non-Government influenced housing fundamentals are far less favorable today than pre-bubble
• As long as there are material numbers of foreclosures in the market (which is the case for years to come), prices will be under pressure

Frankly housing prices could be forced higher if the Government has the political will to do further economic damage and perpetuate unsustainable distortions. A concern is that prices do not fall to sustainable levels, but instead languish for a decade and are eroded by inflation.

As you state, housing is undoubtedly local. But it is ALSO national. I find it fascinating that people seem to gravitate to one explanation or the other when it is so obvious if one analyzes how the price of a house is determined that it is both. If you are looking at an individual house, then local conditions are certainly more relevant, but mortgage availability, mortgage characteristics, interest rates, etc… still matter.

The highly correlated national Housing Bubble was due to macroeconomic factors, not local. Prices in effected cities rose around 1997 and behaved in a correlated fashion for a decade. The recent collapse occurred because of national mortgage market conditions and overall economic fundamentals. And more recently the Government stabilized April/May prices with national programs. ($8,500 rebate, 4.8% subsidized mortgage rates, 3% down loans, etc…)

But you are absolutely right that there are plenty of markets that have stabilized or may be rising. And each house, neighborhood, city, county and state is unique. My analysis typically relates to the national market.

Your thoughts on the Boomers are really interesting and bear further analysis.

I believe and wrote an unpublished piece that demographic influences are more likely to result in further price pressure than to absorb investment properties. They haven't saved enough for retirement, in general, and their largest asset is steadily eroding in value. I need to dust the article off and publish it.

But you make an interesting argument. Boomers certainly have been conditioned to voraciously consume debt and speculate on real estate. But expectations and perceptions of risk change are changing by the day. They spent their entire lives in an environment where real estate was local, owning a house was safe and prices had never dropped nationally.

I note that sales of annuities (fixed and variable) are setting all time records as Boomers flee risk. A friend of mine in London argues that this will be another financial bubble in the future as firms selling the products underestimate liabilities and risk to sell now and capture huge fees (sound familiar?) I think the longer housing prices continue to fall, the less likely your scenario is likely to materialize. But it is an interesting counter-trend. The Government certainly a wild card though.

I have a hard time believing that the current Administration would pay investors to buy houses, but I continue to be shocked by the public policy response to the downturn, so I guess anything is possible. They also are skilled at bailing our industries while making it look like it is not a bailout (Cash-for-Clunkers being the latest disaster).

Thanks again.