CME housing futures

DeForest McDuff
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Last summer, the **Chicago Mercantile Exchange** began trading **housing futures contracts** on the Case-Shiller Home Price Indexes for 10 major US cities. The Case-Shiller Home Price Indexes are the gold standard in the academic community (and now the financial community) for measuring home price appreciation over time. **Robert Shiller**, of course, is the author of the popular book, **Irrational Exuberance**, which called for the implosion of the tech bubble in the 1999 edition and is calling for the implosion of the housing bubble in the 2005 edition.

The futures markets are currently predicting home price declines in all 10 cities from February 2007 to February 2008 (data from www.cme.com):

Futures Prices for February, 2008

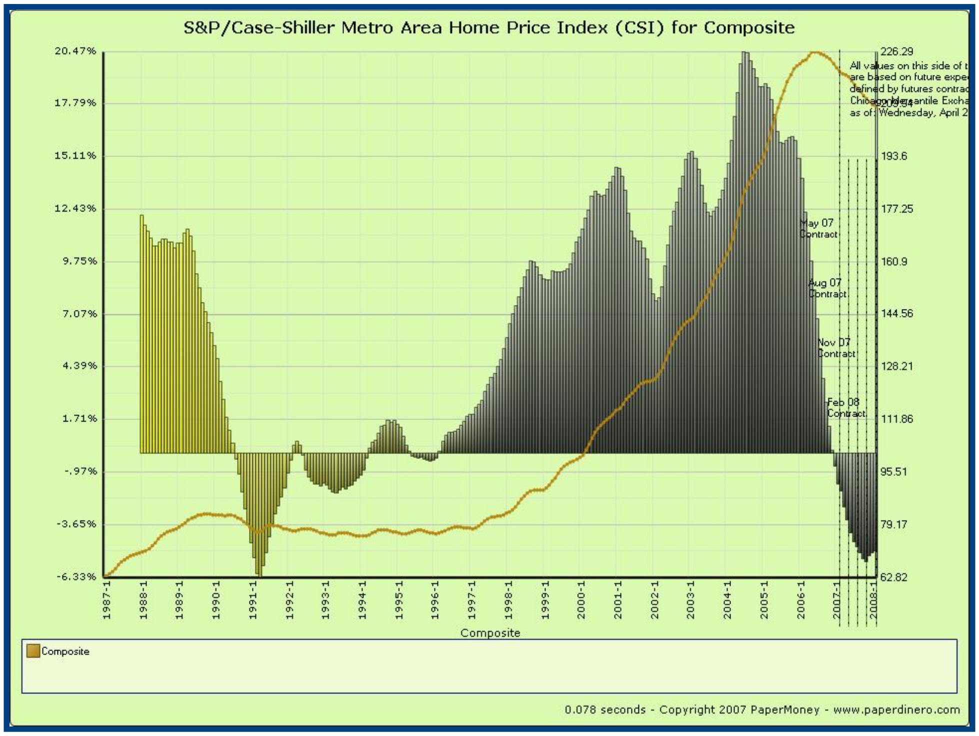
	Feb-07	Feb-08	% Change
Composite	219.9	209.0	-5.2%
Boston	168.0	158.4	-6.1%
Chicago	167.5	162.0	-3.4%
Denver	134.9	128.6	-4.9%
Las Vegas	229.6	217.0	-5.8%
Los Angeles	266.6	255.2	-4.5%
Miami	279.4	266.2	-5.0%
New York	210.7	198.2	-6.3%
San Diego	235.5	223.0	-5.6%
San Francisco	210.8	201.4	-4.7%
Washington DC	237.6	225.0	-5.6%

The futures markets are predicting an average decline in these cities of 5.2% in the next year. And I'm not sure things will look any better one year from now.

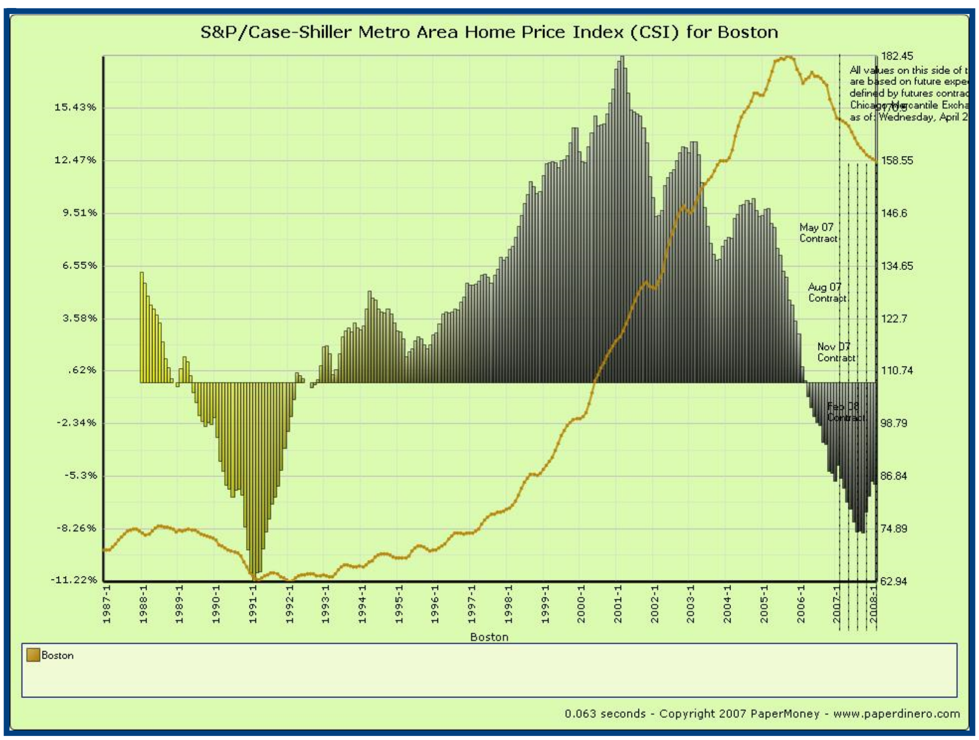
Take a look at the graphs below of the last 20 years of home prices, and you can draw your own conclusions.

The web site **Paper Dinero** has produced graphs for all 20 cities currently tracked by the Case-Shiller Home Price Indexes (note: only 10 of these cities have futures markets). **Note that all values to the right of the first quarter 2007 represent futures contracts and have not actually occurred yet (they are projections).** Click on the pictures to see the full versions.

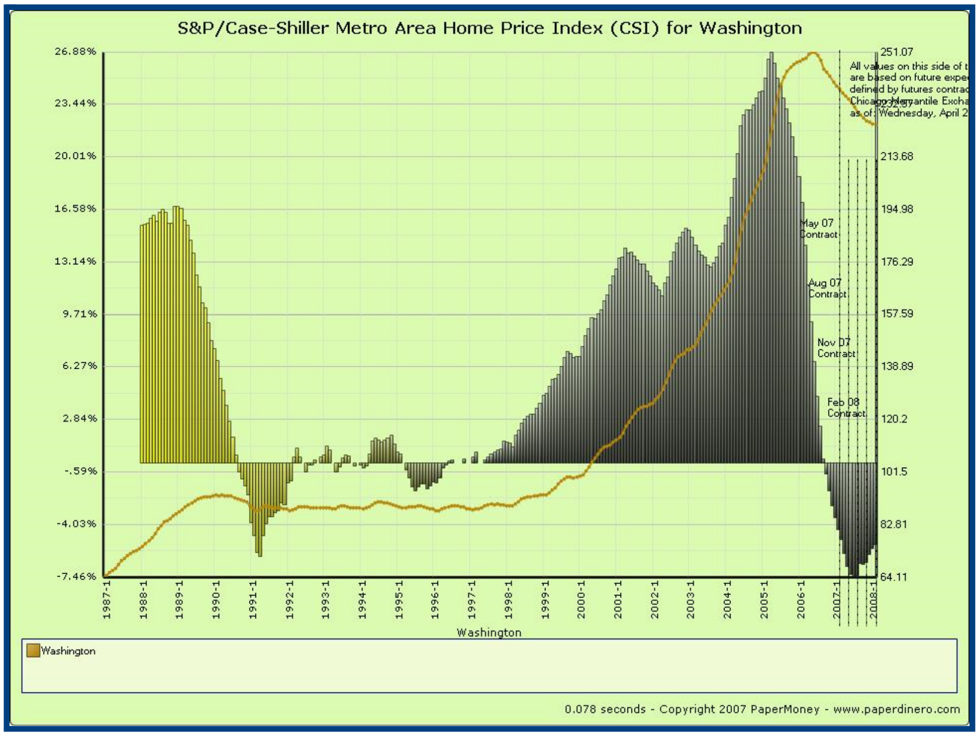
Graph 1: US Composite Index
(looking peaky?)



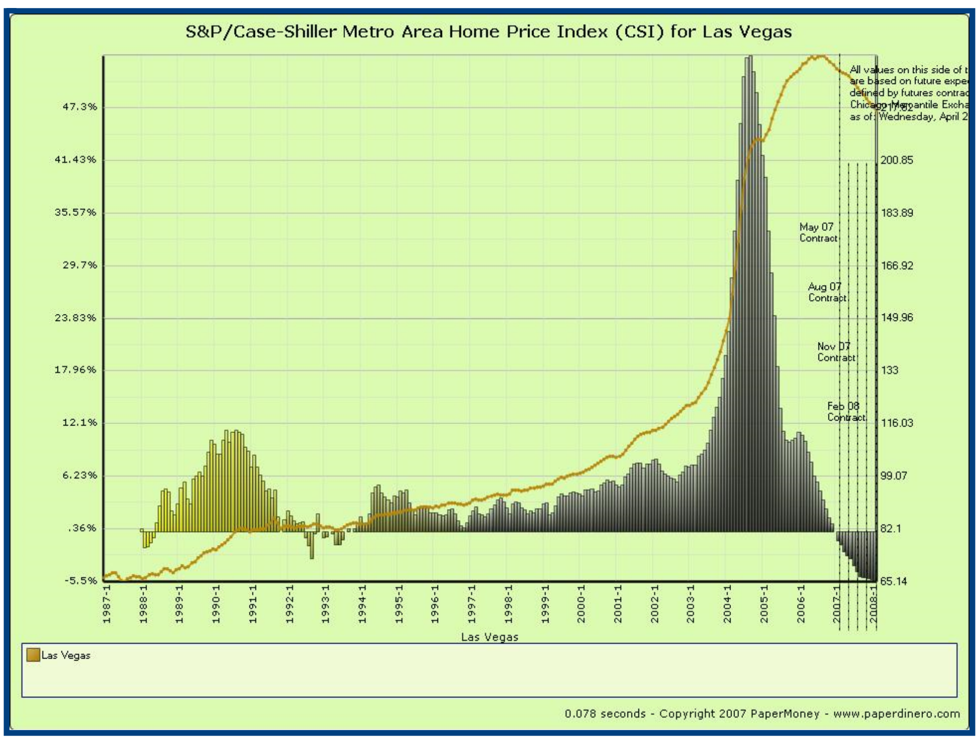
Graph 2: Boston
(always one of the housing market front-runners)



Graph 3: Washington DC
(does this city look in trouble or what?)



Graph 4: Las Vegas
(forget about it…)



From 1996 to 2003, the US housing market was experiencing a normal housing boom cycle, which last maybe 10-15 years from peak to peak. During this time, year over year gains were strong but not unusual. But then from 2003-2005, 50-year-long lows in the Fed funds rate (and thus mortgage rates) combined with new liquidity from **mortgage-backed-securities** opened the flood gates for money into real estate. Easy money and a housing surge soon turned into speculation. The result: just look at Las Vegas prices in 2003-2005.

There is a reasonable argument, maybe, that prices are just rising to a new plateau - that this price appreciation was long overdue. Or maybe we're just in a new housing paradigm (where prices grow at over 5% per year indefinitely??). The problem is that rents have not been keeping up (see my December 2006 post on **Price to Rent Ratios**). If housing really has become scarce relative to the population, then shouldn't we see rents increasing as well? Rents are rising for sure, but nowhere *near* the speed of home prices in the last 5 years.

My view is that most of the price appreciation from 2003-2005 was bogus and that these **real estate indexes will decline by at least 15% in the next few years**. That may not sound like a lot, but if you only put a 20% downpayment on your house, you've lost almost your entire investment. Certainly the degree of speculation and higher-than-sustainable prices vary substantially by location, and so will the price declines.

Of course, all of this depends on whether the decline happens quickly or slowly. A faster decline means nominal prices will actually fall. A slower decline means that prices may only fall in real terms (after adjusting for inflation). Either way, we're probably looking at negative inflation-adjusted price appreciation for years to come.

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