Why home prices will continue to fall

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Preview

According to the latest S&P/Case-Shiller home price indices, home prices fell 7.7% nationally in the last year. This may seem like a big drop, but don't expect a bottom anytime soon.

The futures markets for next year look even worse:

	Futures Market, Nov-07		
	Nov-07	Nov-08	Change
Composite	205.09	184.80	-9.9%
Boston	167.40	155.00	-7.4%
Chicago	161.61	154.00	-4.7%
Denver	133.36	127.00	-4.8%
Las Vegas	201.95	182.60	-9.6%
Los Angeles	240.43	204.00	-15.2%
Miami	237.99	200.00	-16.0%
New York	203.88	194.00	-4.8%
San Diego	209.60	189.00	-9.8%
San Francisco	195.49	183.00	-6.4%
Washington DC	223.45	208.00	-6.9%

Unfortunately, home prices are beginning to fall at precisely the same time credit conditions are deteriorating. The same easy credit that helped home prices on the way up will be equally devastating on the way down as it ceases to exist. At some point, residential housing will once again be a bargain for investors, but I don't expect this to happen for at least 2-3 more years.

The Still Overvalued U.S. Housing Market

It is hard to believe that less than a year ago financial pundits were arguing about whether U.S. home prices would decline at all. These days, it is pretty much common knowledge that prices peaked in 2005 and 2006, but there is still disagreement as to how far and how long they will fall. I can't tell you how many times I've seen reporters and financial analysts on television calling a price bottom right around the corner. Have they even looked at a price charts? Do they know what the futures markets are saying? Have they studied past housing bear markets? In this issue, I hope to debunk the myth that the housing decline will turn around anytime soon.

By almost any measure of home valuation (price-to-rent ratios, income-to-rent ratios, etc.), home prices are still way too high. In the last year alone, home prices fell 7.7% nationally, according to the S&P/Case-Shiller home price indexes (see **NYTimes: S.&P. Home Price Index Continued to Fall in November**). Although mortgage rates have softened recently, the credit contraction has just begun and will only add fuel to the fire.

I expect home prices to fall by at least 20% nationally and by as much as 50% in some markets from their 2005 peaks. Declines adjusted for inflation will be even larger. Home prices will continue to fall for at least another 2-3 years, and I would not be surprised if home prices in the bubble markets are still below their peak levels in 2015.

The Case-Shiller Home Price Indices

The Standard and Poor's/Case-Shiller home price indices began trading on the **Chicago Mercantile Exchange** in May of 2006 and are essentially the gold standard for measuring home price appreciation over time. The futures markets give us an indication of what investors and traders are expecting from housing in the next year.

Almost one year ago, **I wrote about the CME futures markets and their predictions for home prices**:

> "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."

Well, it's almost a year later, and the home price decline seems to be just getting started. The November index release shows that prices have **already** fallen below last year's predictions, and it's only been 9 months:

	Futures Market, Feb-07			Actual, as of Nov-07		
	Feb-07	Feb-08	Change	Feb-07	Nov-07	Change
Composite	219.9	209.0	-5.0%	219.90	205.09	-6.7%
Boston	168.0	158.4	-5.7%	168.00	167.40	-0.4%
Chicago	167.5	162.0	-3.3%	167.50	161.61	-3.5%
Denver	134.9	128.6	-4.7%	134.90	133.36	-1.1%
Las Vegas	229.6	217.0	-5.5%	229.60	201.95	-12.0%
Los Angeles	266.6	255.2	-4.3%	266.60	240.43	-9.8%
Miami	279.4	266.2	-4.7%	279.40	237.99	-14.8%
New York	210.7	198.2	-5.9%	210.70	203.88	-3.2%
San Diego	235.5	223.0	-5.3%	235.50	209.60	-11.0%
San Francisco	210.8	201.4	-4.5%	210.80	195.49	-7.3%
Washington DC	237.6	225.0	-5.3%	237.60	223.45	-6.0%

The futures markets for next year look even worse (this is the same chart as in the Preview section above):

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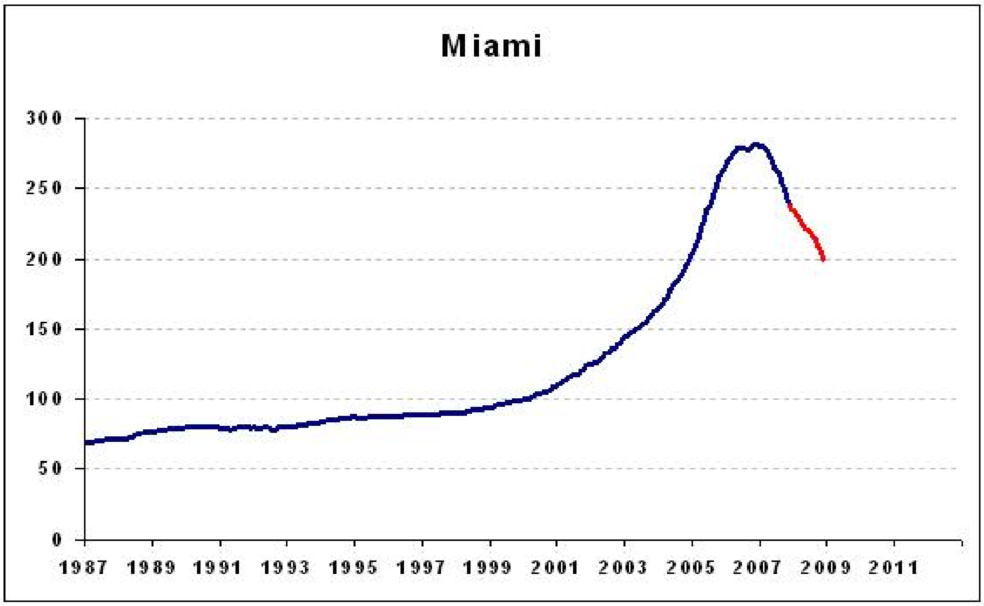
While the futures markets have no guarantee of accuracy, if anything they were too optimistic last year. A 9.9% decline would be the biggest annual housing decline on record. Still not convinced? Let's move on to some price charts.

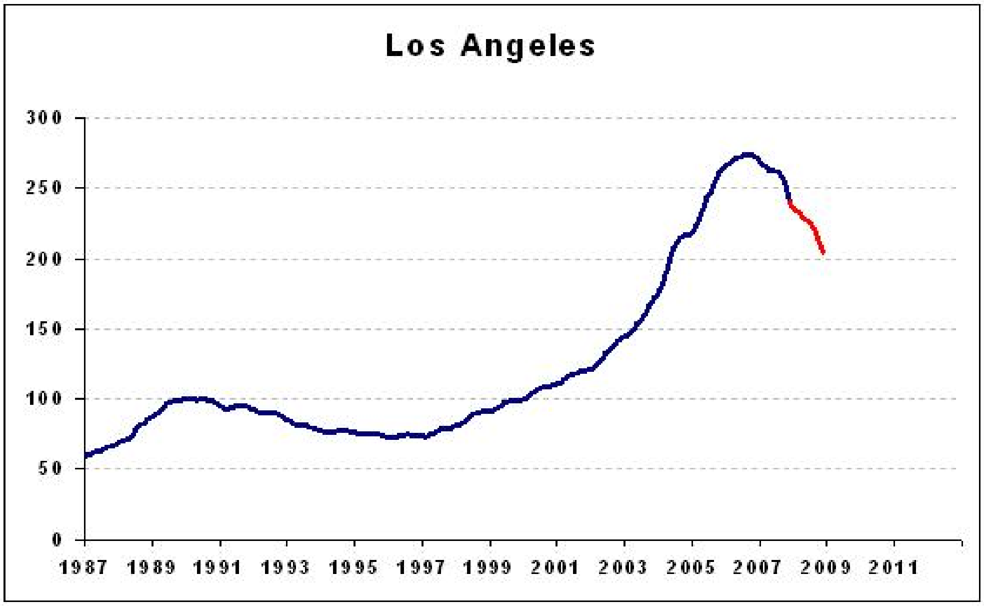
The Glamour Cities

For some reason, the glamourous cities like Miami and Los Angeles tend to attract the most speculative money. These cities have the biggest upswings in a price boom, but the bigger they come, the harder they fall. Speculation is based on explanations what home prices will rise forever, since "there will always be demand for housing in cities like Miami and LA." Maybe so, but at what price?

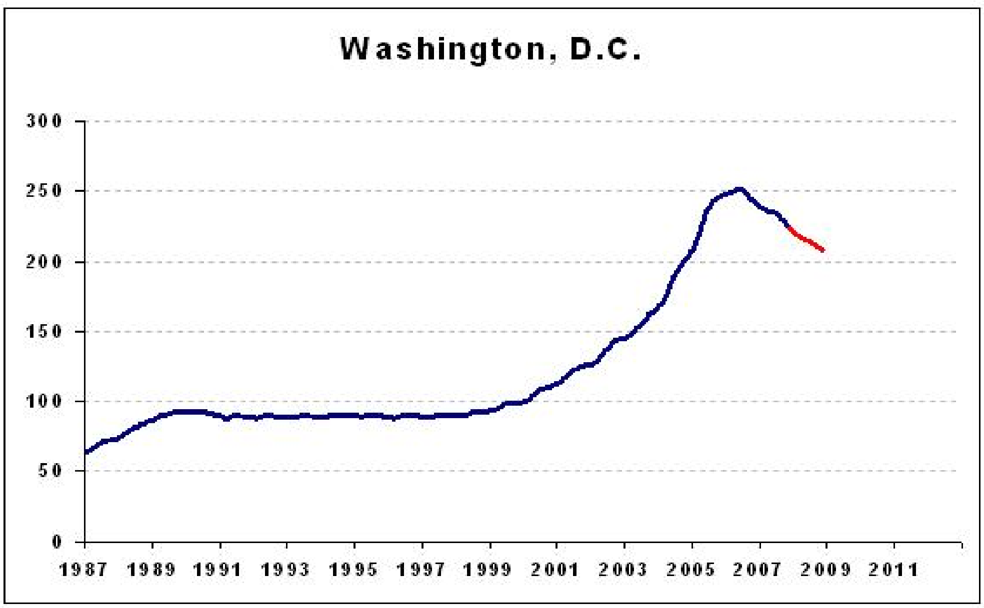
Below are the home price indices for some of the bubble cities in California, Florida, and the Northeast. **The blue line is the actual home price index so far and the red line is the price path predicted by the futures markets.**



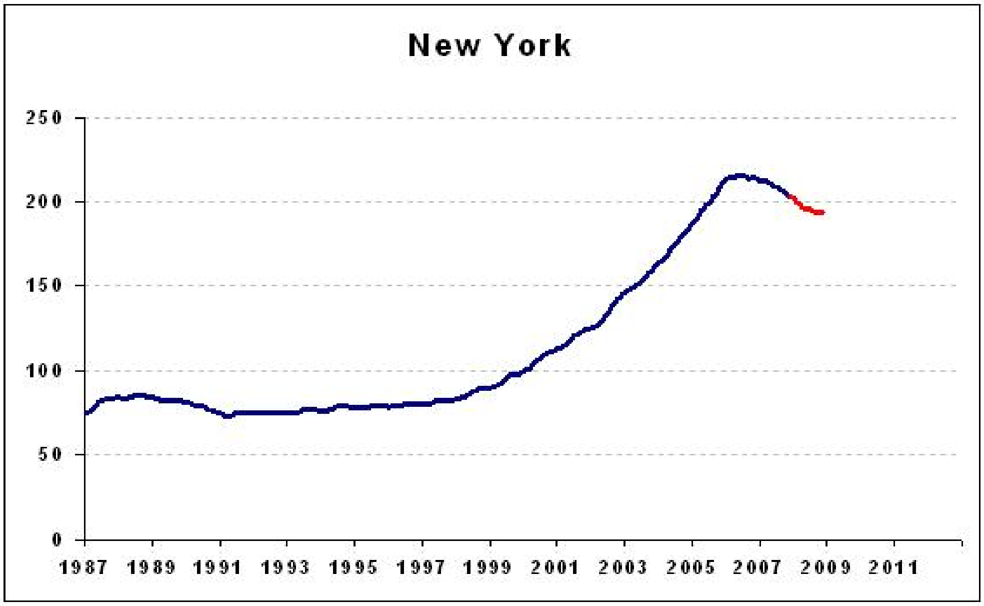
Florida seems to be the front-runner in the national home price decline. Home prices in Miami and Tampa have dropped 15% already, and the state is basically in a housing-led recession.



California will be taking some serious heat once more homeowners default on all of the crazy mortgages they got themselves into in the last few years. Adding foreclosed homes to the market won't help the already record-level inventory of homes on the market. Who knows when prices will bottom out.



Washington D.C. doesn't look quite as bad as Miami or Los Angeles, but the market still increased by 150% in just 8 years. Did rents increase by this much? I think not, but there is a future time and place for that discussion (in the May issue). Overall, I expect markets like DC to decline by 25% from the 2005 peaks.



New York is a tricky market because it has been held up so far by money from Wall Street and abroad. But despite this extra demand, I expect New York prices to fall at least below the 2003 levels after adjusting for inflation.

Click here for the price charts for all 20 Case-Shiller home price indices.

Looking Forward

After the last housing boom in the late 1980s, home prices declined for 5 years and stayed flat for another 5 years. Considering the length and size of the most recent boom, I don't see how we will reach the bottom any faster than that this time around.

Consider also that mortgage rates were falling throughout the last bear market in housing. This time around, mortgage rates are about as low as they can get. The real risk is if long-term interest rates begin rising. If this happens, that will be the nail in the coffin for the housing market.

The availability of cheap mortgages with no money down allowed millions of Americans who would otherwise be unable to buy houses to get into the market. Homeownership rates are at decade-long highs, and so are housing inventories. Now that mortgage credit is drying up, who will buy the excess homes?

Based on the charts above and my studies of housing bear markets, I know I'm not a buyer yet. Maybe in a few more years.

Conclusion

The rapid appreciation of home prices in the last decade is unprecedented in scale. Rising home prices were coupled and fueled by expanding credit and Wall Street mortgage securitization. Unfortunately, both trends have reversed at the same time. Home prices are falling at precisely the same time credit is contracting. The result is falling home prices for years to come.

I finish with the following quotation from a NYTimes article by Peter Schiff, **NYTimes: Frozen Rates, Falling Prices**:

"Everyone seems to agree that a return to traditional lending standards is a good idea, but no one seems willing to accept a return to rational prices as a consequence.

While the bubble was inflating, self-serving explanations were offered for why traditional formulas of home valuation no longer applied. As it turns out, the laws are still in effect. These traditional measures, like the relationship between home prices, rents and income, indicate that prices need to fall at least 30 percent more nationally. The sooner this balance is achieved, the sooner lenders will again commit capital."

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