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Musings & Amusings

George Carlin

"Give a man a fish and he will eat for a day. Teach him how to fish and he will sit in a boat and drink beer all day."

"Is a vegetarian permitted to eat animal crackers?"

"Life is not measured by the number of breaths we take, but by the moments that take our breath away …"

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Pop Quiz … During the past year, U.S. house prices have fallen (a) 15.3 percent (b) 7.7 percent (c) 4.6 percent or (d) all of the above. If you picked (d), you're right! I'll discuss these below. My assessment is that we're at least half way and maybe two-thirds of the way through a very painful adjustment. Prices will stabilize sometime during the first half of next year. Meanwhile, housing poses some significant risks to the economy.

The Case-Shiller Home Price Index (a) was developed by two prominent economists, Carl Case of Wellesley College and Robert Shiller of Yale. It is a "repeat sales" index that tracks the price changes reported to municipal authorities in 20 major U.S. cities. All single family home sales are covered, including foreclosures and homes sold by owners. A ten-city composite is the basis for the home price futures and options traded on the Chicago Mercantile Exchange. More about this later.

The National Association of Realtors measure (b) is the change in the median price of homes sold by Realtors. This is not really a price index, which would track the change in the price of the same or similar houses over time. Rather, it compares the average price of houses sold in a recent period to those sold in an earlier period.

Finally, the Office of Federal Housing Enterprise Oversight or OFHEO index (c) is also a repeat sales index. OFHEO covers the entire U.S., but only for homes with "conforming" mortgages, i.e., those eligible for sale to Fannie Mae and Freddie Mac. Until very recently, these were capped at $417,000, but that limit is being raised to more than $700,000 in some parts of the country.

Which is the best? All suffer from the fact they don't include the "non-price concessions" that proliferate in buyers' markets. If the buyer requires that you install a new roof or re-pave the driveway, the selling price doesn't reflect these out-of-pocket costs.

The Realtors' data are probably the least useful in measuring true price changes. The average is sensitive to shifts in the mix of housing. If cheaper houses are now selling faster than more expensive dwellings, the average selling price could fall even if no individual houses lost value.

The OFHEO measure is biased upwards because it includes none of the properties financed by sub-prime mortgages, which have experienced the most severe problems thus far. However, it does have very broad coverage and considerable geographic detail.

Case-Shiller has the advantage of encompassing all transactions, but the ten and 20 city indexes are disproportionately weighted towards areas with the most severe real estate problems. Price declines are most dramatic in parts of Nevada, California, and Florida where the housing feeding frenzy was most severe. The problem in Detroit is not one of speculation (prices rose slowly during the national boom), but a tough economy due largely to the problems in the auto industry.

Generally speaking, the Northeast has fared better than average. Boston has been rather stable, and metro New York City has held up well. One reason for Boston's fairly positive experience is that jobs have been growing.

House Price Trends

Percent change from 12 months ago*

	Case Shiller	OFHEO
BOSTON	-6.4	-1.8
CHICAGO	-9.3	0.2
DALLAS	-3.4	3.8
DETROIT	-18.0	-6.1
LAS VEGAS	-26.8	-12.1
LOS ANGELES	-23.1	-8.3
MIAMI	-26.7	-5.4
NEW YORK METRO	-8.4	-0.6
SEATTLE	-4.9	2.8
CONNECTICUT		-0.5
MASSACHUSETTS		-1.8
RHODE ISLAND		-3.0
UNITED STATES	-15.3	-4.6

*Case-Shiller and OFHEO U.S. total are April 2007 to April 2008. OFHEO cities are Q1 2007 to Q1 2008.

The discrepancies between Case Shiller and OFHEO are very large. In light of these, it's been suggested that we average the two indexes. I'm not sure what this accomplishes.

These differences are also apparent from forecasts of house prices. The *Wall Street Journal's* monthly survey asks 55 national forecasters for their predictions of the OFHEO index. They see it falling 6.4 percent this year and 2.4 percent in 2009. Based on some back of the envelope calculations, my interpretation is that by late June 2008 we were about half way though the total decline in home prices projected by the *Wall Street Journal* panel of prominent prognosticators. (In the interest of full disclosure: I'm part of that survey.)

As noted above, the Case-Shiller data are used in trading futures and options contracts. These have been available since 2006 for each of ten major cities and a ten-city composite that is often used as a proxy for a national home price index. The futures contracts provide a forecast of house prices.

Looking back, the ten-city composite peaked in June of 2006 and had fallen 19 percent by April 2008. Looking ahead, the futures contracts see a further decline through May of next year with prices starting to firm after that. The total decline from 2006 to 2009 is expected to be about 30 percent of which we've already experienced 19 percent through April.

Hence, we're two-thirds of the way though the adjustment using Case-Shiller and the futures markets. Using the OFHEO index and the *Wall Street Journal* survey forecast, we're about halfway through. I think this is a more useful way of using the Case-Shiller and OFHEO data than simply averaging them.

Neither the Wall Street Journal nor the futures markets tells us why prices will eventually stop falling. It has a lot to do with supply and demand – as well as psychology. The large inventories of unsold homes should start shrinking in coming months. After posting a huge decline, sales of existing homes have stabilized in recent months, which is good. However, new home sales continue to weaken, which is not good. Since existing homes account for about 85 percent of total home sales, overall demand actually may be in the process of stabilizing. On the supply side, construction of new homes has plunged, but the large volume of foreclosures is still adding to the inventory.

To a significant degree, home values – like beauty – are in the eye of the beholder. Prices will stabilize when buyers are willing to bet that values won't fall any further. Sellers also have to realize that their homes simply won't sell for what the neighbor's house fetched a couple of years ago.

While the end is in sight, there's still a considerable amount of downside risk from the worst U.S. housing bust since the 1930s Depression.

More foreclosures are ahead. Research indicates that the greater the drop in home prices, the bigger the increase in foreclosures. As prices fall, people having trouble making their monthly payments find it much more difficult to deal with their problems by selling their homes or refinancing their mortgages. Also, the incentive to walk away from their financial obligations increases as falling prices lead to negative equity where the mortgage balance exceeds the value of the home.

Declining home values have helped erode consumer confidence and household wealth. In May, confidence plunged to the lowest reading in 16 years. During the final quarter of last year and the first quarter of 2008, household net worth dropped more than $2 trillion due to falling home values and declining equity share prices. No doubt that the decline in wealth continued into the second quarter as home prices fell further and the stock market sold off in late June. This is a major drag on consumer spending.

In combination with soaring gasoline costs, falling house prices into 2009 will make it difficult for the U.S. economy to rebound quickly. Those much-discussed tax rebate checks boosted the second and third quarters a bit but their effects are being swamped by housing and the rising costs of necessities. The outlook is for sluggish or slightly negative economic growth in late 2008 and early 2009 followed by a modest recovery. This means that the Federal Reserve won't raise interest rates until house prices and jobs stop falling – which is sometime during the first half of 2009.

The housing bill working its way through Washington as I am writing this will provide some relief. It is aimed at those homeowners who can't afford their current mortgages but would be able to make the payments if the lender forgave part of the loan. The government would then guarantee the re-structured loan. If the homeowner eventually sells the property, then any gain will have to be split with the government. However, the legislation may fall short of what's needed to deal with the number of potential foreclosures that lie ahead. More government actions may be needed to lift housing.

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