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Foreclosures, Fish Food and the Final Fall in Home Prices

Highlights

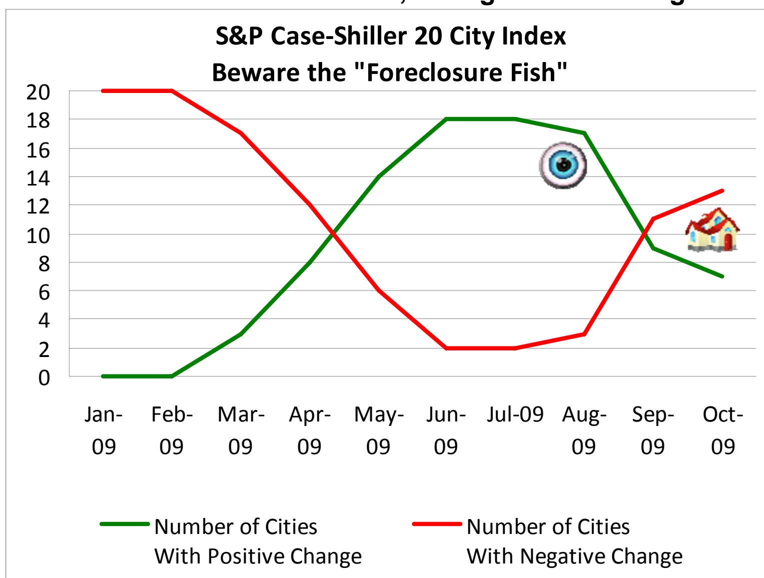
- The S&P Case-Shiller 20-City Index October data, released between Christmas and New Year's Day, sent a clearer signal on the housing market's final tumbling act. The exhaustion of previously pent-up demand reflected in declining sales of both new homes and pending existing home sales announced last week further brings reality into focus.

- We expect that the index, and housing in general across the nation, will decline to, and ultimately stabilize at, a point approximately 8% to 10% below the lows reached last April, to a reading of about 125 to 128 on the CS20 Index. As we have noted previously, contrary to certain other analysts who believe that expected additional prices deterioration will be concentrated in states that have seen the worst price depreciation to date, our view is that the lion's share of the remaining decline will occur in markets that saw sizable bubbles but have not yet retrenched by an amount comparable to bubble era inflation (relative to other markets).

- We continue to believe that home prices cannot truly stabilize until they are rationalized relative to the growth in rents, inflation and incomes during the bubble period—and this process is likely to occur in an environment in which rents are flat to falling on a real basis, creating a further challenge to home price stabilization.

- October's flat/down data contain the proof positive of deterioration in 13 of the 20 metropolitan statistical areas included in the CS20 Index, with the only positive markets being those on the West Coast that were hit harder and earlier (during the bubble and upon its demise) by the massive dislocation in home prices, plus the otherwise anomalous Detroit market. Even the Washington, DC, market, previously decline-impervious, was down in October.

Table 1: The Foreclosure Fish, Rising Versus Falling MSAs



- This is particularly alarming, given the "time-shifting" that occurred last year, which forced pent-up demand usually met in spring (during which, last year, housing and other markets were moribund) into the late summer and early fall. Apparently, the belated "selling season" did not continue to push prices into the fourth quarter.

- While much has been made of a pickup in existing home sales and a decline in "visible" inventory available for immediate sale (although new home sales have declined in recent months[1] and December saw an equally greater-than-expected decline in pending exiting home sales), an increase in "shadow" inventory levels—total residences repossessed by lenders (REO), homes in foreclosure and homes with mortgages 90 days or more delinquent—to 1.7 million units, from 1.1 million at the end of 2008[2], has left total inventory (visible + shadow) at the same elevated level (approximately 5.5 million units, or nearly a year's supply). Those reading too much into sales statistics, relative to this supply and the wall of worry that threatens in the coming year, do so at their own risk.

- And that wall of worry is steep, indeed. According to RealtyTrac, U.S. foreclosure filings reached 3.9 million in 2009, another new record. With the volume of total inventory and approximately a third of all mortgaged homes already underwater relative to the mortgages thereon, there can be no expectation, absent a dramatic turnaround in the U.S. economy (that feeds, to no small extent, on the housing industry and consumer home values), that home prices have stabilized.

Overview

For several months, we and other housing-market observers have agreed that calling any sort of end to the decline in home prices is premature. Too many factors remain stacked against the market—and any positive signals we received late last year are traceable to unsustainable government intervention, including federal homebuyer tax credits (and a state program in California) and extremely low mortgage interest rates on conforming loans.

In that connection, it is also important to recognize that much of the interim housing price improvement in recent months has been concentrated not only in severely damaged West Coast markets (with price drops of 40% to more than 50% from peak-bubble pricing), but also in the lower-end, more mortgageable homes in multiple markets.

The S&P Case-Shiller 20-City Index data released between Christmas and New Year's Day sent a clearer signal on the housing market's final tumbling act.

We expect the index, and housing in general across the nation, to decline approximately 10% below the lows reached last April, to a reading of about 125 to 128 on the CS20 Index. We continue to believe that home prices cannot truly stabilize until they are rationalized relative to the growth in rents, general, labor and materials inflation and incomes during the bubble period. This process will occur in an environment in which rents are flat to falling on a real basis, creating a further challenge to home price stabilization.

October's flat data (actually down .07%) contain the proof positive of deterioration in 13 of the 20 metropolitan statistical areas included in the CS20 Index, with the only positive markets being those on the West Coast that were hit harder and earlier (during the bubble and upon its demise) by the massive dislocation in home prices, plus the otherwise anomalous Detroit market. Even the Washington, DC, market, seemingly impervious to declines since spring, was down in October.

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[1] In truth, we believe the drop in new home sales more accurately reflects the exhaustion of previously available and heavily discounted "standing" inventory, as opposed to a commentary on the market's demand side. New home sales will pick up again, as residential development land continues to be repriced and sold at values making the delivery of new homes approximately competitive with existing inventory. There will always be a market for properly priced new homes.

[2] Source: First American CoreLogic

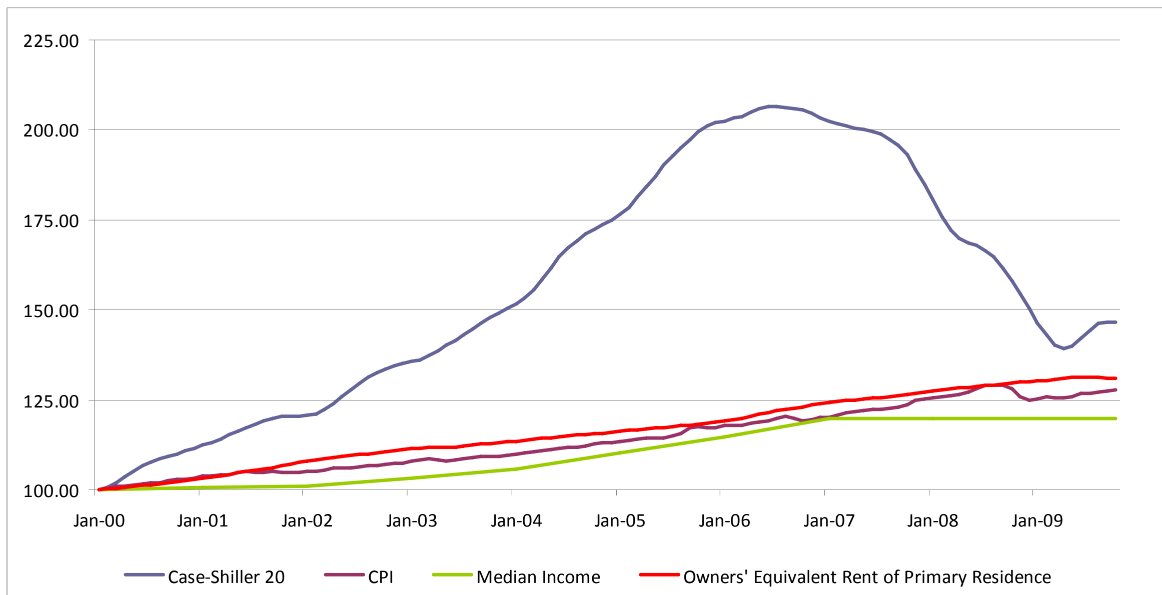
On page 1 of this report, we reintroduced our "Foreclosure Fish" graph, which now resembles (in our warped way of looking at things) a fish gobbling up home prices. We believe the "fish's" mouth will open increasingly wider, until we again see several months of declines across the board (in our view, the denouement of the housing bubble). We expect homes will stabilize at the lower price levels mentioned earlier in this year's third or fourth quarter.

The Inexorable Retreat

Beginning in late 2007 and early 2008, we expressed the housing bubble in terms of home prices' departure from all other indicia of value, including rents, inflation (construction and labor costs, in particular) and incomes.[3] Effectively, with construction and materials' costs rising less than inflation, housing's inordinate price inflation was really nothing more than a senseless bubble in land prices—caused, as has finally been universally accepted, by a combination of low interest rates, lax lending and a lack of regulatory oversight of financial institutions.

While prices have readjusted substantially, there remains across the board a modicum of additional price decline yet to come on a national level—much more than a modicum in some markets and nearly zero in others—to restore pricing to rational levels. The good news, as Table 2 demonstrates (indexing CPI, median income and rent to the CS20), is that we're almost there.

Table 2: Almost There, But What a Ride!



Sources: Case-Shiller 20-City Index (SPCS20R), BLS CPI All Items and Real Owners Equivalent Rent Index, McGraw-Hill Engineering News Record

The bad news is that the final act in housing's readjustment will have the greatest impact on homeowners (who have already lost $6 trillion of home value) and, more disturbingly, on financial institutions. We believe that when the market finally stabilizes, some 40% to 45% of all mortgaged homes will be underwater and that virtually all of the remaining decline in the value of mortgaged homes will come on the backs of lenders (with homeowners having been pretty much wiped out by declines to date).

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[3] More detail on our thinking can be found in our reports, "Putting a Floor Under American Homes" and "Reconstructing American Home Values," of August 2008 and August 2009, respectively.

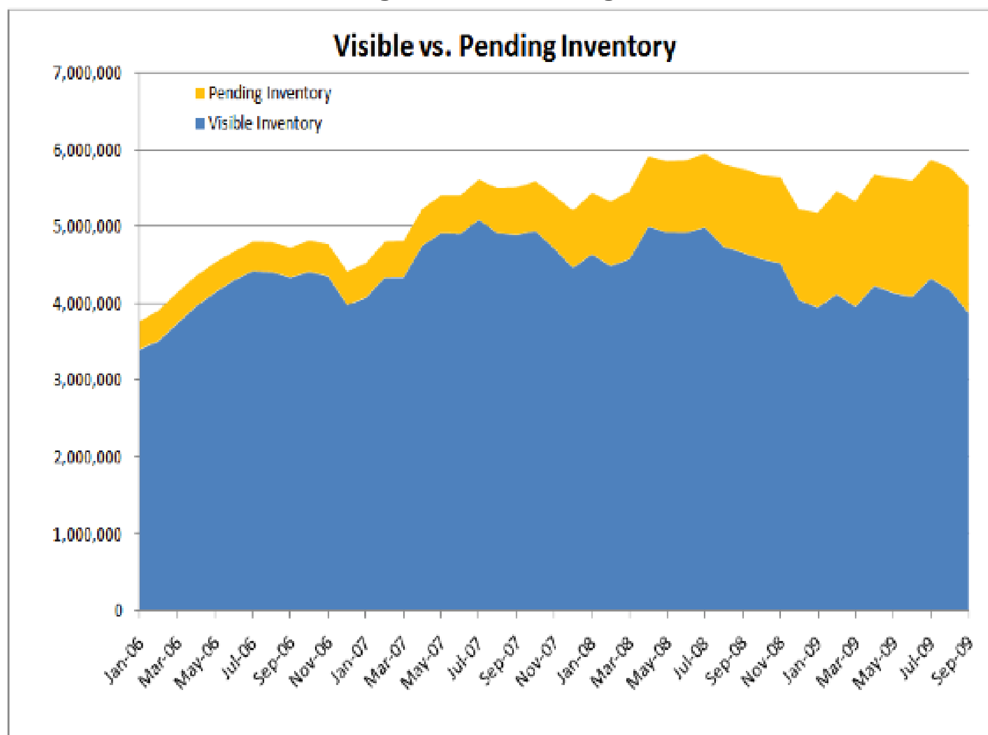
Suspect Supply and Sales

December's greater-than-expected decline in pending existing home sales and the recent declines in new home sales are, among other things, evidence of the beginnings of exhaustion of pent-up housing demand (built up during the moribund year from Q3 2008 through Q2 2009) and have garnered headlines. But the real story is hidden in the shadows of the supply side (made only worse by the prospect of declining demand).

The number of homes estimated by First American CoreLogic to be in the "shadow" inventory that will likely be thrust on the market in coming months totaled 1.7 million units at the end of 2009, up from 1.1 million at the end of 2008. Shadow inventory includes total of residences repossessed by lenders (REO), homes in foreclosure and homes with mortgages 90+ days delinquent, but are not—for a variety of reasons—being marketed for sale. As additional mortgages enter the stages of chronic default and foreclosure, shadow inventory increases.

While the amount of visible housing inventory fell materially from its 2008 peak by year-end 2009, the increase in shadow inventory has left the housing glut at roughly the same 5.5 million units at which it has hovered for the last several years, since the bubble burst. At the current sales pace, this amounts to about a year's supply of available homes (see Table 3). Of course, the more that inventory is "in the shadows," the fewer transactions occur – hence the recent drop in sales. Releasing inventory into a saturated market depresses prices. Pick your poison.

Table 3: Nothing Much Has Changed in Inventories



Source: First American CoreLogic

Shadow inventory is building, in large part, because liquidation timelines (from date of first default) have lengthened considerably over the last two years and are now averaging nearly 18 months.[4] Whether this is because of overclogged servicing and/or legal apparatus in the United States, or whether it is the result of banks

[4] Source: Amherst Securities

kicking the can down the road as long as possible to avoid taking losses (we favor the latter explanation), is a matter of some debate. Regardless, the rate of total foreclosure filings has exceeded 300,000 per month since February 2009, and while the rate has declined in recent months, the November 2009 pace was 18% higher than that of the same period in 2008 (despite the self-imposed moratoria and foot-dragging by many lenders seeking to postpone the inevitable, and the less-than-effective mortgage modification program that has come out of the Obama administration).

Speaking of the latter, we believe the administration's unfortunate decision to promote a mortgage modification program that fails to deal with loan principal reduction has delayed the final housing correction by perhaps six to 12 months. It is estimated that only 1.5 million of affected homeowners are eligible for the Home Affordable Modification Program (HAMP), and only a few hundred thousand have been able to avail themselves of it to date. Evidence is clear that redefault rates on seriously underwater, mortgage loans modified under HAMP and otherwise, exceed 50% in the first 12 months after modification, and we believe many owners of underwater homes, even with lower payments, will ultimately surrender their residences in favor of either renting or purchasing dramatically cheaper homes in which they can eventually build equity.

We acknowledge that principal reduction and forgiveness are fraught with complex issues (i.e., moral hazard, the impact of the banking system). But we see little choice in stemming the tide of foreclosure inventory, other than by keeping people in their homes. (See our companion opinion piece issued today, *Resolving Underwater Home Mortgages—A Hazard to Who's Morals?)*

Conclusion

We wish we could join the chorus that believes the housing market has bottomed nationally. While we think many markets found a temporary shelf in 2009, many others have not yet sufficiently adjusted, and even the most substantially corrected of markets may be vulnerable to the dumping of additional inventory (or, in several markets, to the addition of unsold inventory to the rental market, placing downward pressure on rents). As the value of shelter is now becoming relinked to the cost of renting, falling rents will continue to challenge the stabilization of the owner-occupied market.

Some markets continue to astound us with regard to excess inventory. Our home market of New York is one of them. As with southern coastal Florida and several other major urban areas throughout the United States, the New York metropolitan area saw an enormous wave of mostly high-rise condominium construction and sales. When the music came to a stop in New York (far later than when the game of musical housing sales stopped elsewhere), there were about 22,500 vacant, newly constructed or converted condominiums that have been overhanging the market ever since (nearly 30,000 in the entire metropolitan area). In the nation's most highly priced residential location, Manhattan, there are presently about 8,500 vacant units. To put this into perspective, this amounts to nearly 100% of all existing, plus new, residences of any type (condominium, co-op or townhouse) sold in a typical year (2006 = 9,000 units total) in Manhattan. MillerSamuel, a leading residential appraisal firm in New York, estimates that at the current sales pace for vacant new construction or conversions in Manhattan, absorption of excess new units could take six to seven years.

Of course, such lengthy absorption periods are out of the question, given carrying costs. Lenders will ultimately either fire-sale units or sell them to rental-apartment operators, with both options depressing prices throughout the market.

In this respect, New York is a microcosm of the rest of the country. Rents and prices will not find their final resting place until underwater mortgages are worked out, inventory is absorbed and substantially increased employment reduces delinquency and foreclosure rates to pre-crisis levels.

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