NMHC

Beware of Volatile Housing Prices

Data challenges some of the wealth-building assumptions of home ownership. **By Mark Obrinsky**

The continued surge in housing prices has fueled a debate over whether they have reached unsustainable levels. Whether prices can continue to rise not only affects current and prospective homeowners, but it also has implications for housing policy debates.

For decades, federal housing policy has favored homeownership, but in recent years it has tilted even further, pushing homeownership among low- and moderate-income households under the theory that homeownership is the surest path for such households to build wealth. But an increasing number of critics are beginning to question the aggressive homeownership push in general, and the wealth-building potential in particular.

In today's world of vanishing down payments, a potential housing bubble takes on more significance. For families with loans that require no down payments, even a modest decline in housing prices could lead to severe hardship if they were forced to sell and found themselves owing more than their houses are worth. An analysis by the National Multi Housing Council finds evidence that policymakers and prospective buyers should be cautious.

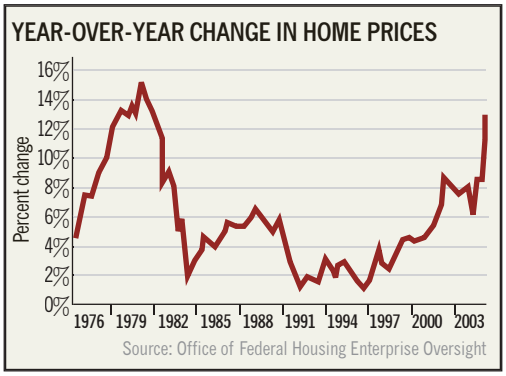
Data can be misleading

One of the most quoted claims by homeownership advocates is that single-family house prices have never declined in a calendar year. This implies that new homebuyers are somehow shielded from a price decline.

At first blush, the evidence appears to support this view. Looking at data from the National Association of Realtors (NAR) and the Office of Federal Housing Enterprise Oversight (OFHEO), prices have indeed increased each calendar year. But this data has several limitations.

First, the data tracks nominal home price appreciation. If you look at inflation-adjusted house prices, they have actually been negative almost one-third of the years for which OFHEO data is available. This has a significant impact on the "wealth building" assumption.

Second, homeowners have considerable discretion over when they sell. If prices decline, owners can opt to remain in place as long as they are not forced to sell because of financial or personal circumstances. Thus, even though the actual value of the house may have declined, it would not show up in the data on house prices.



National home price averages do not tell us anything about the price appreciation of individual houses. For example, a 4% gain in the average house price could mean that all houses rose by 4%, or that half rose by 12% and the other half fell by 8%. OFHEO data for 265 metro areas paints a much more volatile picture of home prices and suggests that house price declines are more prevalent than commonly thought.

Every one of the 25 largest metro areas — home to more than 40% of the U.S. population — has experienced a decline in house prices at some point during the 30 years for which data is available. To be sure, not all declines were large. But most areas went through a period of considerable depreciation. Among the top 25 metro areas, one (Houston) saw a 25% decline.

Is there a housing bubble now?

While house price declines can have different causes, in most cases, substantial depreciation has followed unusually rapid and sustained appreciation — typically several years of double-digit price gains. Both nominal and real house price appreciation in the last seven years have been stronger than at any time since the late 1970s. This, plus the previous cyclical nature of house prices, has led to concern about another stock market-like bubble.

Are housing prices really another bubble about to burst? Comparisons to the stock market are surely overblown. Even pessimists don't expect house prices to mimic the 40% fall in the S&P 500 index. What's more, "bubble" is probably the wrong way to think about house prices outside truly supply-constrained areas. After all, if increased demand can elicit greater supply, it is difficult for a true demand-induced mania to take hold.

Still, house prices have shown a past tendency to overshoot the mark, both up and down. Thus, while some bullish analysts expect appreciation to return to more typical levels — about 4% annually — many more expect some sort of catch-up. This could mean a sustained period of relatively flat prices, outright declines, or some regionally dependent mix of the two. The larger the increase in mortgage rates, the more likely or more widespread the outright declines will be.

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