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WEEKEND EDITION

Can home prices avoid the fall?

Bulls, bears clash over America's hot real estate market

By Steve Kerch, CBS.MarketWatch.com
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CHICAGO (CBS.MW) -- Plenty of people are talking about how they think there is a housing-price bubble. Bob Wilson has acted.

The account manager for a Southern California technology vendor sold his Orange County tract home for $665,000 in May, pocketing more than $400,000 in gains. But Wilson didn't turn around and sink his cash into a newer, fancier home. He's stashing his nest egg in cash and gold, renting a nearby house for two years, and waiting for home prices in what he thinks is a overheated Orange County market to tumble. Then he'll step back in.

"Even though one's house has the emotional aspect that stocks do not, a market is a market, and I truly believe there are fundamentals that apply to all types of markets," Wilson said. "They don't go up forever, and they don't go down forever."

"Needless to say, it was a very difficult decision to make with all the memories. After a lot of prayers, tears, and doubts we went for it. It was a kind of seize-the-moment' situation," he said. "We have come across others who have made the same decision, not a whole lot of people, but enough to call it some sort of uncommon trend."

Those who proclaim housing prices have risen too far, too fast and are due for a Nasdaq-style market correction would applaud Wilson's move.

But critics of the doomsday view say home prices are not out of line with economic fundamentals, at least not anywhere but a handful of cities or neighborhoods. They say Wilson and others catching the profit-taker fever may be wishing they had held onto their residential investments.

"The prognosis for the for-sale housing market is good, thanks to improving job growth that is even better than is being reported by local newspapers, historically low mortgage rates that are under significant pressure to decline even further and strong demographics," said John Burns, a real estate consultant in Irvine, Calif.

The debate is playing out across the country, in the media, at cocktail parties, among economists and in the advance marketing for a January summit to be held on the topic in Los Angeles. See Resident

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Too much debt

Bill Staton, a certified financial planner from Charlotte, N.C., says that home prices should be raising red flags.

"I am certainly not predicting a housing collapse like the Nasdaq waterfall, but the facts indicate we could be in for a sustained period of housing price weakness if not substantially falling prices in certain areas like San Francisco. Way too many families are way too stretched in their real-estate obligations, combined with all the other debt they owe," Staton said.

"The bubble is going to pop during the next several years -- if not sooner. Few people will know it because one characteristic of a bubble is that it's hard to tell you're in one until after it bursts. By then, it may be too late," he said.

The consequences to American homeowners' balance sheets could be immense. Buyers who put 20 percent down on a home purchase that falls 10 percent in value would see half their equity wiped out, according Michael Sklarz, chief valuation officer for FNIS, a Santa Barbara, Calif.-based real estate consulting firm.

But Sklarz says the chances of that happening are remote. Instead, the market is more likely to shift from the one in which sellers have been in complete command to one in which buyers have more say. In that scenario, he says, more homes would be on the market, houses would take longer to sell and buyers would have better negotiating power.

"There's nothing as extreme as a bubble," he said. "Some of the markets that are stretched, though, may move sideways for a certain amount of time." See analysis of potential bubble, and potential bargain, real estate markets.

Mortgage rates the key

Both sides of the bubble debate agree on one thing: If it weren't for low mortgage rates, the housing market wouldn't be anywhere near as resilient as it has been.

Looking at a simple comparison of home prices to household incomes, as some housing-bubble proponents do, housing affordability is near a record low, according to a Milken Institute study. But factor in interest rates, which have dropped to 6 percent from about 7.5 percent five years ago, and housing affordability has remained high. See full story.

"The main thing that would threaten to collapse housing prices is a sizable jump in interest rates," Sklarz said. (Will mortgage rates fall to 5 percent or rise slightly from their current level?)

Daniel Ward, a real estate investment and mortgage specialist in Oceanside, Calif., says three other factors could cause a dramatic drop in housing prices: a crisis in derivative investments among large financial institutions such as Fannie Mae and Freddie Mac, a credit squeeze on already overburdened and undersaving Americans or a world conflict that breaks the back of the U.S. economy.

"One last factor to be considered is a psychological one," Ward said. "Value is merely perceived. Markets can turn on a dime. In my opinion, just the mere fact that the debate on whether there is a housing bubble shows a loss of confidence in the strong housing market."

Ward says he thinks the nation already has reached the "peak" of the housing market.

"I believe that every market in the U.S. will be down, and down dramatically -- by as much as 40 percent -- within three to five years. Rates will stay low during this time, so there is no need to rush out and purchase or refinance a home."

Market already less heated

Regardless of whether any prices actually fall, recent data show that the housing market is cooling off. And home-price appreciation has steadily declined from a cyclical peak reached nearly two years ago.

Average U.S. home prices increased by 6.5 percent in the second quarter of 2002 on a year-over-year basis, according to the most recent House Price Index released by the Office of Federal Housing Enterprise Oversight. The number represents a continuing decline from the 9.2 percent gain recorded in the first quarter of 2001.

The second-quarter report showed only one market of 185 nationwide where prices declined year over year -- San Jose. The OFHEO index is considered the most comprehensive measure of home prices because it uses data from repeat sales of the same house, or refinancings of mortgages purchased or securitized by Fannie Mae and Freddie Mac.

"The OFHEO report belies recent media reports of alleged house price bubbles that are forming or about to burst," said Gary Garczynski, president of the National Association of Home Builders.

"It indicates that home values have continued to improve at an historically healthy rate, but with some gradual and expected braking from the exceptionally strong pace at which they were gaining in the beginning of last year. There has been no dramatic slowdown, nor is there likely to be," he said.

Even the most prominent proponents of the bubble theory acknowledge that such an occurrence is unlikely nationally. Rather, they say, individual markets could see significant price declines as happened in New England in the late 1980s and in southern California in the early 1990s.

"Any bubble would have to be localized, maybe even in only one price range of homes. I don't see the extraordinary markup usual to a bubble," said Jack Harris, a research economist of the Real Estate Center at Texas A&M University.

PMI Mortgage Insurance Co. said this month that the risks of home-price declines have increased nationally, although the 32 percent jump in its risk index came from a relatively low level.

Housing fundamentals solid

Yet in many high-priced markets, values have been driven up not by speculative fever but by the fundamentals of supply and demand, said Raphael Bostic, director of the USC Casden Real Estate Economics Forecast.

"When buyers see home prices rising, they decide to jump in to the market while they can still afford housing. This is perhaps the ultimate buy and hold strategy -- just the opposite of speculation," Bostic says.

Population growth, immigration, the strong economy of the 1990s, and the lowest mortgage interest rates since the 1960s have helped to increase demand for housing nationwide, Bostic says.

But supply has not kept pace with demand in many regions because of high land costs, opposition to development, builders' liability concerns and a drawn-out permitting process. Only when the supply-demand imbalance is restored, he said, will prices moderate.

Steve Kerch is the real estate editor of CBS.MarketWatch.com in Chicago.

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