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For the past couple of years, Americans have been living in a fantasyland of double-digit home price appreciation.

High Tide for Housing

By Mark G. Dotzour

The national price appreciation rate of an average house pierced the 10 percent level in third quarter 2004 and did not drop below 10 percent until third quarter 2006.

The last time Americans enjoyed such a fairy-tale residential market was in the late 1970s. Presidents Nixon, Ford and Carter were unable or unwilling to administer the necessary economic medicine to reduce inflation. Housing prices were climbing at a remarkable clip.

Like their counterparts in the 1980s, many Americans today are facing a painful return to "real world" appreciation rates. But before things can return to normal, they may have to get a little bit worse. Here's why.

The Setup

When inflation erodes the value of financial assets, people historically turn to real estate and gold to protect their assets. As inflation soars, home prices rise rapidly. Homebuyers suddenly view their new homes as investments, not just shelter.

For most of the 1990s, homebuyers were buying shelter without considering investment returns. That changed in 2002 when the flagging stock market, weakened by revelations of fraudulent accounting to shareholders, continued to lose value.

The signs were sobering. Hairstylists stopped giving stock tips. No one was bragging about IPO — initial public offering — successes. Real estate once again became the investment of choice. Homebuyers seeking shelter morphed into homebuyers seeking both shelter and investment returns.

As prices rose, homebuyers were joined by investors and speculators, further driving up demand. At the same time, Wall Street was deluged with investors seeking the high yield and relatively low risk of mortgage-backed securities. New capital pipelines tapped into a global tsunami of investor capital desperately seeking yield.

Remember the old caveat that buyers needed to meet Fannie Mae and Freddie Mac underwriting guidelines? Global investors demanded higher yields. To respond to this insatiable demand, financial firms have dramatically increased the risk tolerance for homebuyers.

Traditional barriers to homeownership were razed. "Don't worry," prospective homebuyers were told. "If you don't have a down payment, your credit is bad and you are a little short on income, there is still a loan for you." Some lenders did not even require documentation.

So here we are, awakening from the fairy-tale housing market. The real world is staring us in the face. Everything is back to normal, right? Not quite. Seven waves are washing away the foundation of the national housing market. The residential housing market will have to absorb the blows from these waves before it can hope to be normal again.

Wave 1. Investors Withdrawing

Investors and speculators who were flipping houses looking to make a quick profit have largely exited the market, withdrawing demand. To make matters worse, some of these players have put their acquired properties back into the market to dispose of them, simultaneously lowering demand and increasing supply. Others are losing their investments to foreclosure.

Wave 2. Sinking Second-Home Sales

Second-home and vacation-home buyers buy properties largely for leisure and entertainment. When the housing market heads for the clouds, a second motive enters the calculus. That lakefront house would be fun, but it also could be a great investment.

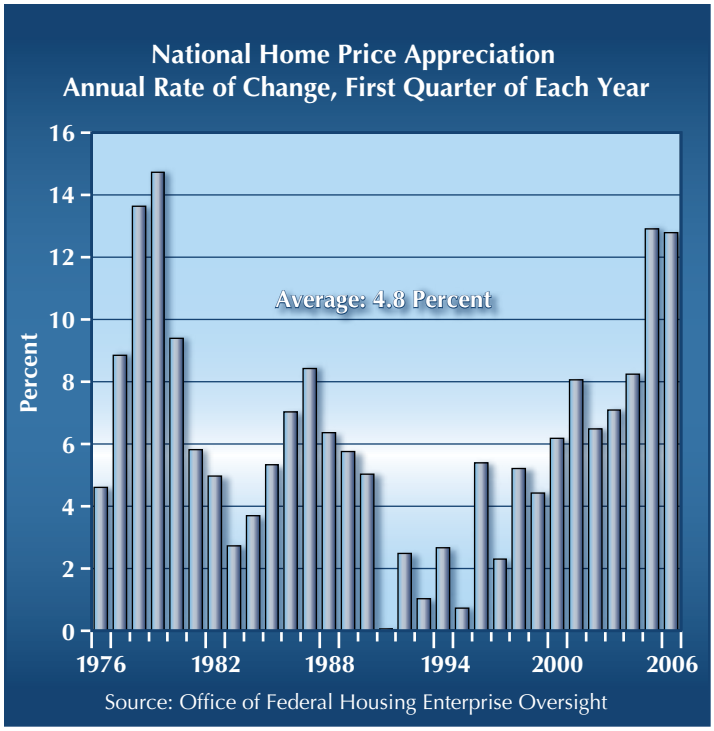
When prices for these luxuries start to decline or flatline, the investment motive disappears as it did in the 1980s and early 1990s. There still will be some people with sufficient wealth to buy second homes and recreational properties, but demand will be reduced as investors leave the arena.

Wave 3. Higher-Risk Loans

We are in the early years of a grand financial experiment in the U.S. housing market. Over the past 40 years, Fannie Mae and Freddie Mac guidelines ensured that most homebuyers would be able to successfully make their payments and experience the many benefits of homeownership. That's why

foreclosure rates in the United States have been low other than during a severe recession, such as the one in 1982.

But in recent years, Fannie and Freddie have ceded a large portion of the home mortgage business to other entities that have been more than willing to extend credit to high-risk homebuyers. Now, Wall Street firms and other mortgage specialists originate mortgages and sell them to investors. These companies look at the business from a different perspective than Fannie and Freddie. To them, the more loans they originate, the more fees they earn. If the foreclosure rate increases, that's just a cost of making loans. No one seems to care whether foreclosures increase, because they are so low to begin with.



Wave 4. Exotic Loans

Exotic loans are one of the manifestations of higher-risk loans. When houses were no longer affordable in some areas of the country, borrowers were offered loans with 1 percent teaser rates, when the actual rate was much higher. This results in "negative am" (negative amortization), in which the loan balance increases each month. When the loan balance rises above the "negative am cap," the payments increase immediately to the market rate.

Many buyers, particularly in California, have purchased homes with these loans, which are basically sticks of dynamite. The fuses have been lit. It's just a matter of time before these bombs explode.

Wave 5. No-Doc Loans

Because of investor thirst for higher yields, bond investors have been accepting securitized mortgages from homebuyers who did not have to verify their incomes or employment. These so-called "no-doc" loans picked up a new nickname — "liar's loans" — after research showed that many borrowers overstated income and understated debts.

Wave 6. Subprime Loans

Subprime lending has been a major growth area for lenders in the past five years. These loans generate significant fees for both the mortgage industry and the mortgage-backed securities industry and provide high-yield bond investment opportunities. When home prices are appreciating, everyone wins.

Recent stories of "2-28" loans illustrate how much risk is inherent in these loans. Sometimes referred to as "exploding ARMs," the low teaser rate on these loans lasts two years. For the remaining 28 years of the loan term, the rate adjusts every six months, often causing dramatic increases in the payments. If house prices are escalating, the homeowner can usually afford to either refinance or sell the home when the ARM explodes. But in the post-fairyland marketplace, more of these homeowners will face foreclosure.

The aggressive way that lenders are seeking out credit-weakened borrowers for subprime loans harkens back to a similar scenario in the manufactured home business in the late 1990s. Then, hyperaggressive lenders took on much higher levels of credit risk in return for high sales. Many of these loans became delinquent and were foreclosed on. Since then, shipments of manufactured homes have been cut by half. Some of these same lending practices have migrated into the single-family housing market.

Wave 7. Mortgage Fraud

Mortgage fraud is now rampant in the United States. Some lenders are cheating borrowers and some borrowers are cheating lenders. The FBI has been monitoring reports of fraud in recent years. The number of cases they are investigating has increased dramatically.

The combination of virtually free money (thanks to the Fed lowering interest rates) and a glut of global capital seeking higher yield investments has fueled aggressive mortgage lending. Now the cost of money has risen and federal regulators are eyeing the mortgage market to see if federal regulations need to be created to crack down on unsuitable mortgage lending practices.

Look for the unbridled supply of cheap mortgage money available to virtually anyone to become harder to get in the second half of 2007. As the cost of mortgage funds increases and the availability of funds for high-risk borrowers gets squeezed, expect home sales volume to decrease in Texas for the first time in more than a decade.

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THE TAKEAWAY

Double-digit home price appreciation over the past two years has created a "fantasyland" residential market in many parts of the country. But now, withdrawing investors, sinking second-home sales, high-risk loans, and mortgage fraud are forcing a return to the real world.

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