A Reprint from *Tierra Grande*

After the Fallout

By Mark G. Dotzour

A year has gone by since the real estate mortgage markets experienced the first day of "nuclear winter."

For three or four years prior to July 2007, the credit markets for real estate lending were on fire. The thinking among the "smart money" on Wall Street was that under modern central bank policies, risk was a thing of the past. The economy would still move up and down, but in much gentler waves, and when things got rough, the Fed could fix it.

"Fix-It" Fed

Remember the Y2K crisis? The Fed fixed it. Remember the stock market difficulties after 9/11? The Fed fixed them. Remember the 1998 Russian ruble crisis and the ensuing credit market turmoil it caused? The Fed fixed it. Even when the stock market crashed in October 1987, the Fed fixed it.

These examples prove the Fed will not tolerate more than minimal corrections in the U.S. economy. Investors have now succumbed to the notion of "The Greenspan Put." This catchy little phrase essentially means there is no longer any risk in the markets that the Fed cannot fix by lowering interest rates.

When global investors perceive no risk, investment capital flows everywhere. Investment prices go up and yields go down. Cap rates on real estate hit record lows. In this kind of environment, how do investors find higher yield? The answer is that they take on more risk. They make home loans to people who cannot afford to pay them back. Then they sell those loans to investors who do not know what they are buying. The profits roll in.

Housing Wheel of Good Fortune

This new "no risk" era has had a remarkable impact on the housing market. Prices started rising and suddenly homes were no longer just places to live — they became investments as well. As prices continued to escalate, investors figured if one house was a good investment, why not buy more?

TV shows began to reflect the popularity of investing in homes. Investors could tune in to "Flip This House," then switch channels and watch "Flip That House."

In post-World War II U.S. history, there have been three barriers to buying a first home: a down payment, a job and good credit.

But early in this decade, the desperate search for yield prompted investors to buy riskier mortgages. Lenders had a new way of doing business. No job? No credit? No cash? No problem! They began making 100 percent loans without documenting borrower financials. Traditional risk management and mortgage underwriting standards that had served well for decades were swept aside.

This new type of mortgage lender went by the name of Wall Street. Mr. Street did not need Fannie Mae and Freddie Mac

underwriting guidelines because he did not sell his loans to Fannie and Freddie. He sold them to all kinds of investors all over the world. These loans were supposed to be virtually risk-free, rated AAA by the most reputable ratings agencies.

In 2006, prices stopped going up. Then they started to decline. Some people stopped paying their mortgages. Suddenly, investors decided not to buy more U.S. residential mortgages from Mr. Street. At this writing, those investors still are not interested in buying new mortgages.

So guess who is left to make the loans? The traditional lenders who made them back in the good old days. Even an old friend — FHA — is looking dapper again and is quickly evolving into the subprime lender of the 21st century.

Where's the Bottom?

Two major events have to occur before the housing market will begin to bottom out. First, home prices have to stop falling, and second, investor confidence in the traditional U.S. residential mortgage must be restored.

What must happen for home prices to stop falling? The answer is a painful process. Prices fall when there are more houses for sale than there are buyers who want to buy (or can afford to buy).

The abrupt "nuclear event" that occurred in July 2007 shut off a substantial amount of demand for new homes almost overnight. The large group of low-income homebuyers that was active in the market in June 2007 was gone completely the next month. Meanwhile, new homes were still piling into the market. The excess supply has continued to grow as foreclosed homes are put on the market.

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This overwhelming imbalance of supply and demand caused prices to fall. Prices will stop falling when the excess supply is eliminated from each local market. This can happen in only one way.

First, new construction must be reduced to virtually nothing. The relentless population growth in most of America will ultimately absorb the excess inventory. The inventory of unsold homes will decline until selections get too limited to meet the needs of picky homebuyers. At this point the market will begin to shift from a buyer's market to a seller's market. Prices will stabilize, and the market will begin to heal itself.

How Long to Heal?

The pace of this turnaround will vary from city to city. If home builders cut back dramatically on new supply, the recovery will occur faster. Communities with fewer foreclosures will work through the excess supply more quickly. Communities with strong job and population growth will create demand that will absorb the excess units faster. Conversely, communities with slow job growth could take years to bounce back from the excess supply.

Political action could change the timeline as well. If the Federal government were to offer tax credits for people to buy homes, the excess inventory could be soaked up even faster. This would cause the housing market to bottom and turn around much faster.

Another stimulus that would speed the recovery is gently rising mortgage rates. Typically, when mortgage rates are falling, homebuyers postpone buying. But when they see that mortgage rates have stopped declining and may rise, they hop off the fence and buy.

As the economy begins to rebound in 2009, look for mortgage rates to take an upward turn. As long as rates do not increase dramatically enough to impact affordability, this should stimulate housing demand.

The long-term outlook for the Texas housing market is clearly strong. In the 1970s and 1990s, house prices in Texas rose in nine out of ten years. And even in the 1980s — the most challenging decade for Texas in the past 38 years — house prices increased eight out of ten years.

Job growth in Texas has doubled the national average for most of the past ten years. Demographic experts estimate another 13 million people will live in Texas by 2030. Many Texas cities still have tight inventories of homes for sale with prices continuing to appreciate.

The state's metropolitan areas have strengths and weaknesses in their local markets. Attractive properties located in older neighborhoods close to downtown are still performing well and will continue to do so. The challenges in big city housing markets will be in select sections of the suburban perimeter. In the short term, these markets will struggle because too many new homes have been built. But even in these areas, supply is being quickly withdrawn as new home starts plummet. It may take a few years for these areas to return to a balanced supply.

For now, builders are accepting substantial concessions to make a sale. If you plan to buy a house to live in for a number of years, this would be a great time to buy. If you think you may not live in a house for two years before you move again, you might be better off to rent.

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THE TAKEAWAY

The "no-risk" environment of the past few years spurred lenders to make risky loans and investors to buy those loans. Before the U.S. housing market can begin to bottom out, prices have to stop falling and investor confidence in traditional mortgages must be restored.

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979-845-2031

Tierra Grande (ISSN 1070-0234) is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year. Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University. The Texas A&M University System serves people of all ages, regardless of socioeconomic level, race, color, sex, religion, disability or national origin. Photography/Illustrations: Real Estate Center files, p. 1.