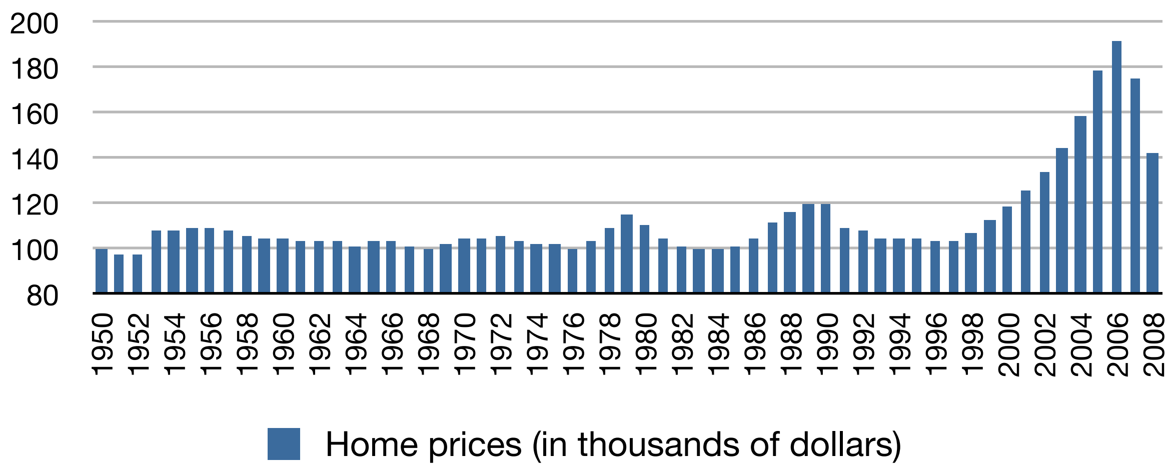
Why home values may take decades to recover

by Dennis Cauchon, USA TODAY

The history of housing as an investment

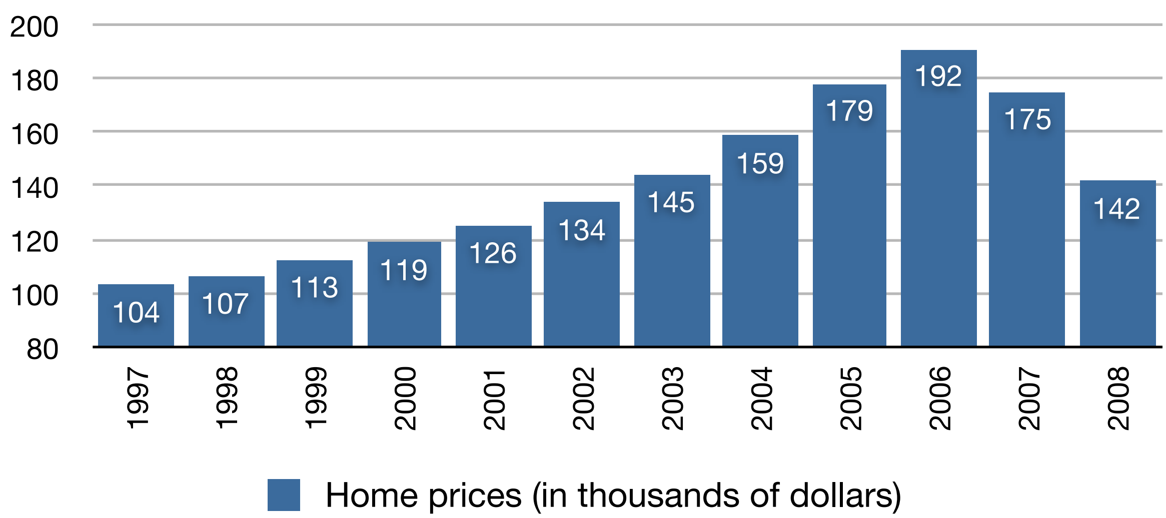


Source: Economist Robert Shiller, Yale University

Homes were once for living, not investing. Throughout the 20th century, homes were stable, unspectacular investments. The average annual investment return from 1950-2000 was less than one-half of 1% per year, after adjusting for inflation.

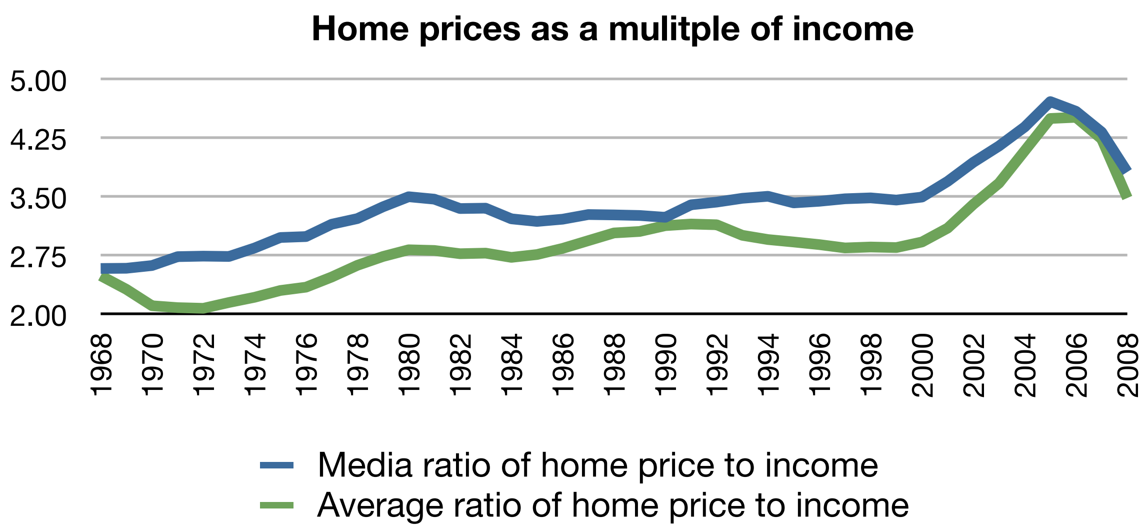
The chart above shows what happened to money invested in a home from 1950 to 2008. The home price index was set to start at 100 in 1950. So, a $100 investment in a home in 1950 was worth $104 in inflation-adjusted dollars in 1997.

The bubble decade



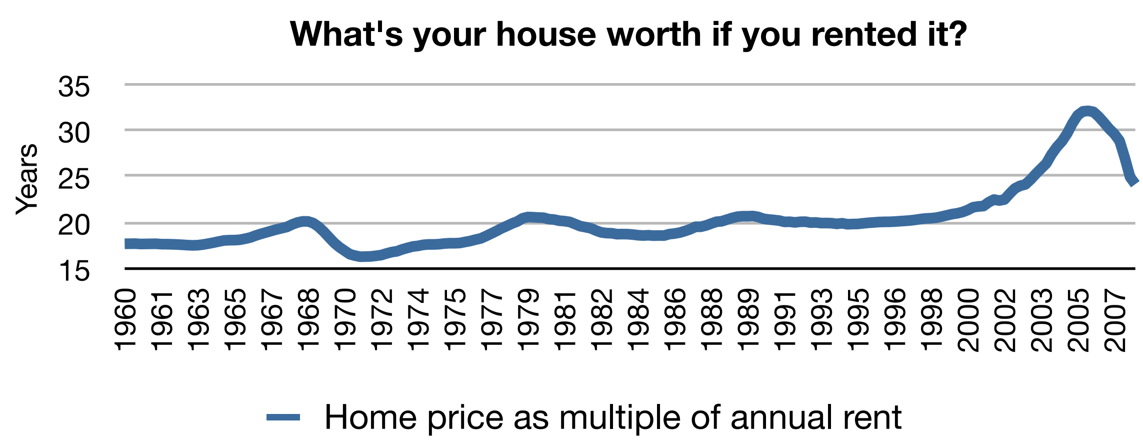
Source: Economist Robert Shiller, Yale University

The housing bubble began in 1998, peaked in 2006 and burst in 2007.



Source: Census Bureau, S&P/Case-Shiller Home Price Indices

How far can home prices fall? A long way, if prices return to their traditional level. Historically, home prices have been equal to about three times average household income. In 2005, they peaked at 4.5 times income.



Source: Economist Morris Davis, University of Wisconsin; USA TODAY research

Economists also measure home prices based on how much it would cost to rent the house. Historically, homes cost about 20 times what it would cost to rent the home for a year. A house that rents for $10,000 a year — about $830 per month — would be worth about $200,000.

In 2005 and 2006, home prices peaked at unprecedented levels — 32 years' worth of annual rents. In other words, a house that could fetch $830-a-month in rents was selling for $320,000, far above its traditional value of $200,000.

Getting back to stability		
How much do prices need to fall to reach traditional levels?	Decline needed from peak to reach historical level	Decline needed from today to reach historical level
Home price based on traditional appreciation	-43%	-24%
Home price based on household income	-33%	-17%
Home price based on rental value	-32%	-18%

Source: USA TODAY analysis

How much U.S. house prices must fall to reach levels that existed, with little change, from 1950-2000.

What the decline means in dollars		
Valuation method	Median home	Average home
Home price at peak in 2006	$221,900	$301,333
Home price today	$199,161	$244,792
Home value based on traditional appreciation	$151,362	$186,042
Home value based on household income	$165,303	$203,177
Home value based on rental value	$163,312	$200,729

Source: USA TODAY analysis

A home worth $300,000 may soon be worth $200,000 or less.

How did prices get so high in the first place?		
Median downpayment	1989	2007
All buyers	20%	9%
Repeat buyers	23%	16%
First-time buyers	10%	2%

Source: National Association of Realtors

Leverage. Buyers borrowed more and put less of their own money into home purchases.

The traditional 20% down payment became a thing of the past during the housing boom, especially for first-time buyers. In 2007, 45% of first-time buyers used “no money down” loans, a mortgage that essentially did not exist before the late 1990s. Millions also obtained adjustable-rate mortgages (ARMS) that offered low interest rates at the beginning but later re-set at much higher rates, causing homeowners’ monthly payments to soar.

Home buyer leverage ratios		
	1989	2007
All buyers	5-to-1	11-to-1
Repeat buyers	4-to-1	6-to-1
First-time buyers	10-to-1	50-to-1

Source: National Association of Realtors; USA TODAY analysis

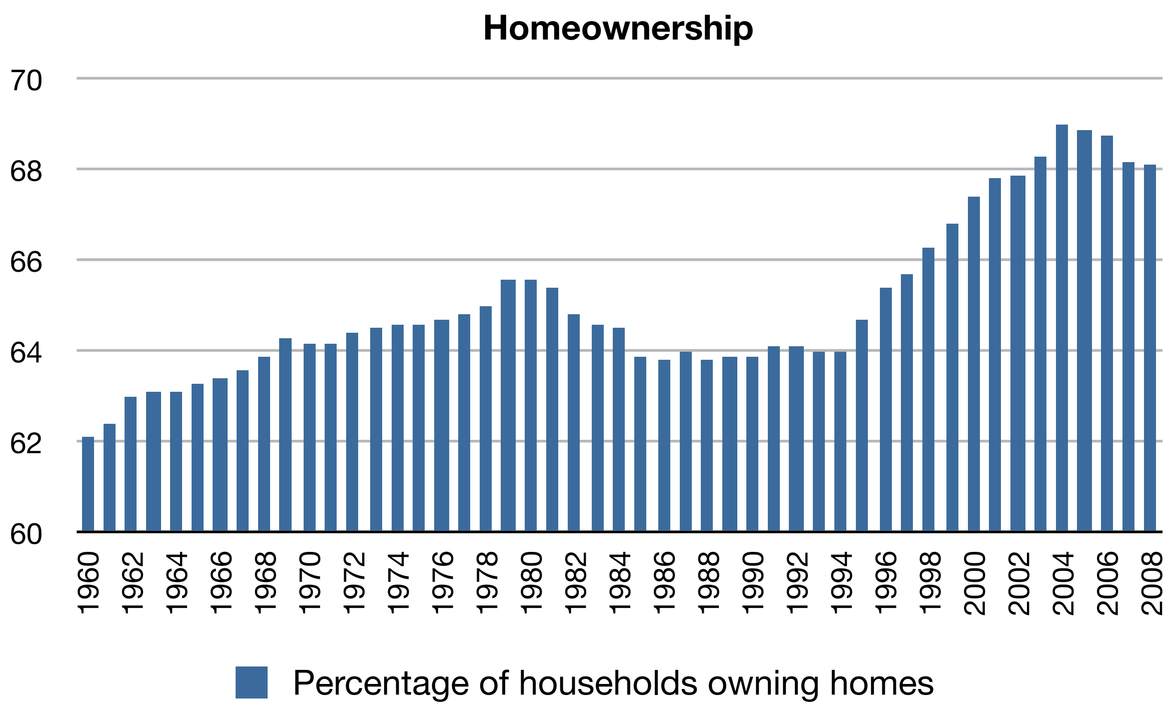
A typical bank puts about 9% of its own money into its business, a leverage ratio of 11-to-1. Lehman Brothers, the failed investment bank, had a leverage ratio of 30-to-1, meaning it borrowed and invested $30 for every $1 of the company’s own money.

During the housing boom, home buyers leveraged small down payments into big mortgages to buy more expensive houses than they could otherwise afford.

The power of leverage		
Purchase price	$300,000	$300,000
Downpayment	20%	5%
Home equity	$60,000	$15,000
If home value rises 5% in value to $315,000…		
Increase in home price	$15,000	$15,000
Return on equity	25%	100%

Source: USA TODAY analysis

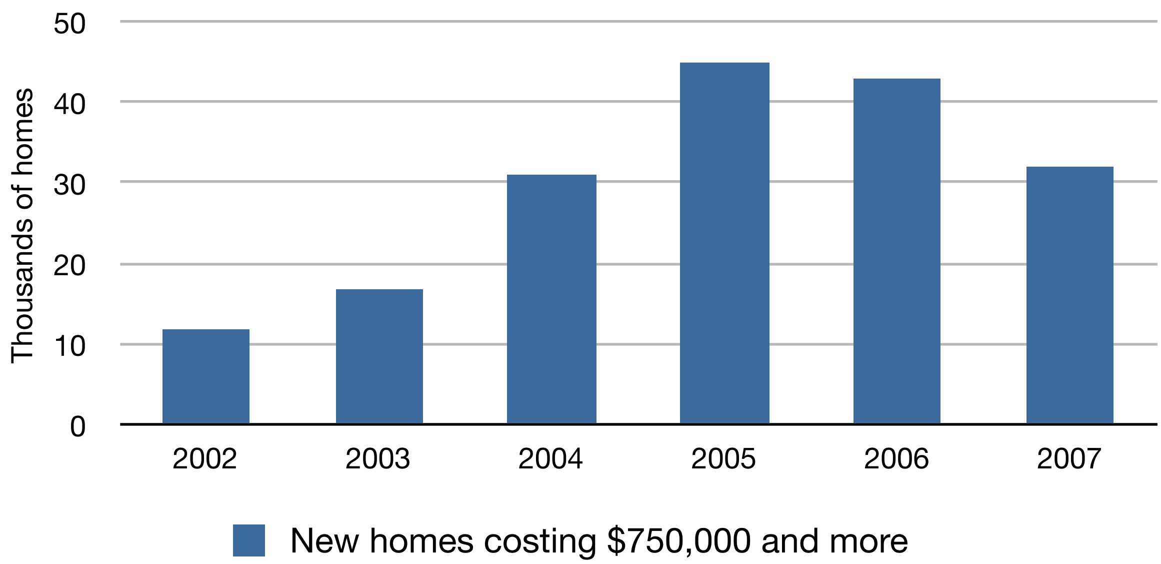
Leverage increased the risk to homeowners and borrowers. Just as important, it magnified profits. The investment return on a home depends on the amount of equity, not the purchase price. Some homeowners doubled and tripled their investments every year during the housing bubble, a tribute to the power of leverage. Small down payments, low interest rates, adjustable-rate mortgages and interest-only payment options made buying a home affordable to low-income people who had previously rented.



Source: Census Bureau

Rates reached historic highs during the housing bubble.

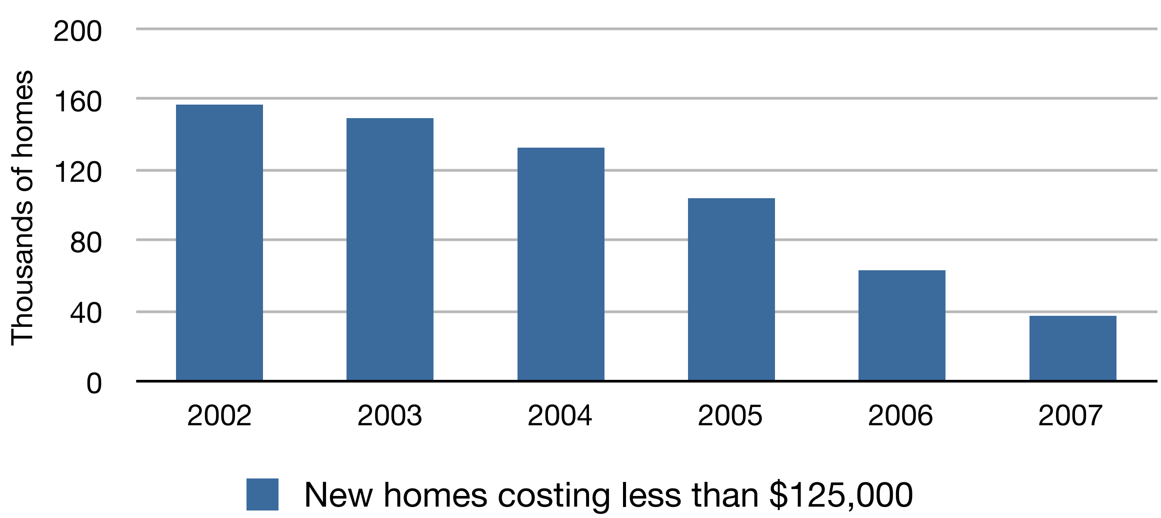
Lower-income buyers weren't the only ones to benefit



Source: Census Bureau

A rising tide of easy lending made the $1 million McMansion and the $750,000 beachfront condominium hot commodities. New homes got bigger and more expensive across the board. The largest growth came in homes costing $200,000 to $300,000.

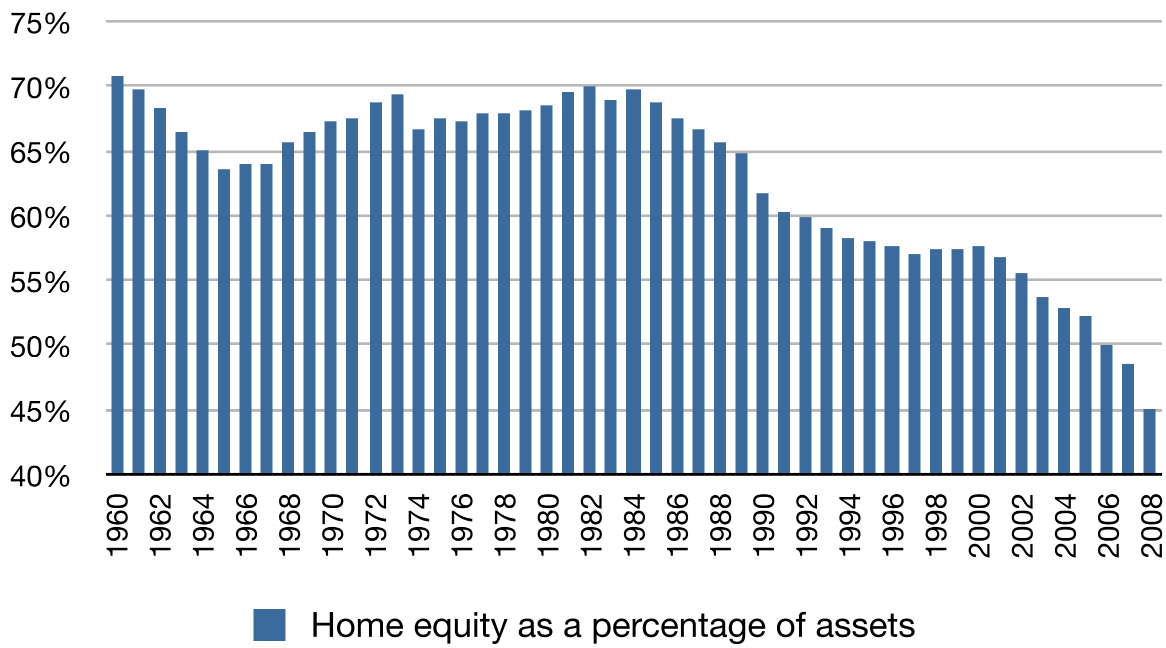
The bust in cheaper home sales



Source: Census Bureau

Sales of inexpensive homes plummeted after 2002 as high-risk mortgages proliferated.

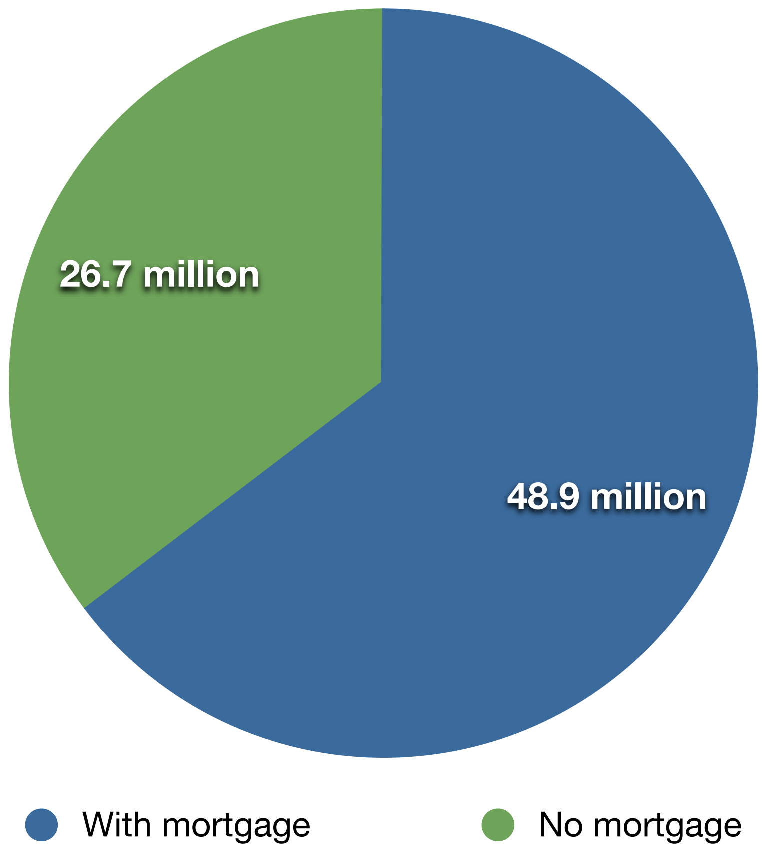
Home equity levels have hit historic lows



Source: Federal Reserve Board

Soaring home values gave the illusion that homeowners were getting rich. In fact, home equity shrank during the boom. Home buyers were borrowing faster than their home values were rising — a sign of a debt-induced bubble. Home-equity loans were a big reason.

Millions of homeowners are mortgage-free



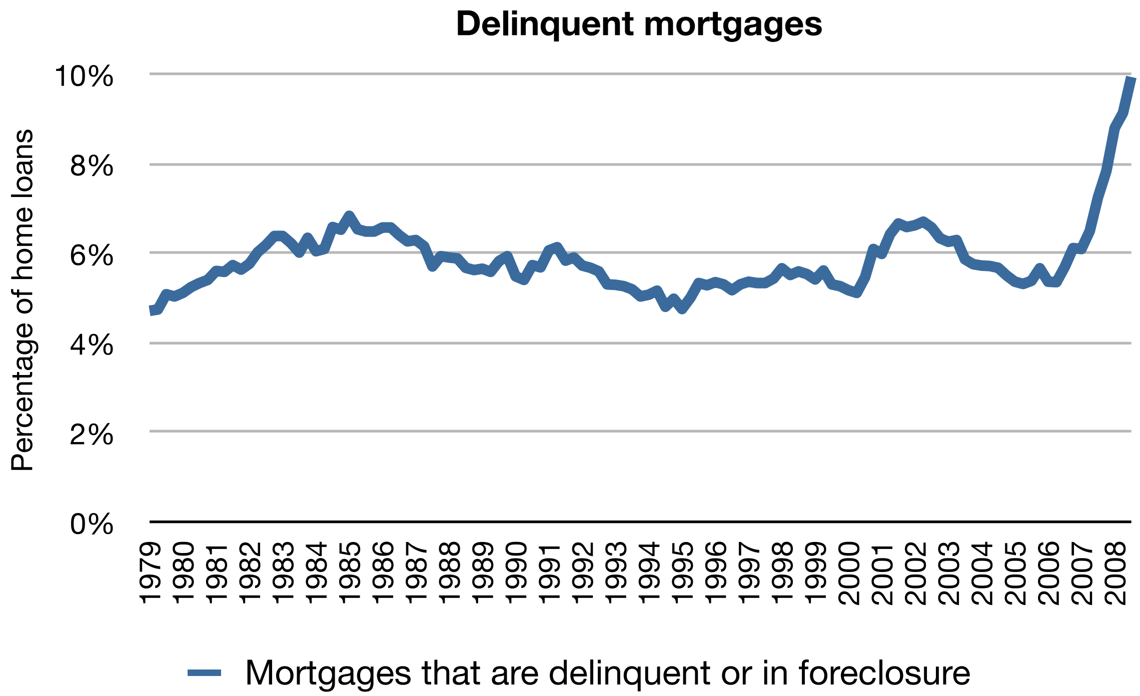
Source: Census Bureau

About one-third of homeowners, many of them seniors, have no mortgage, owning their houses outright. For those with mortgages, home equity has shrunk to historic lows. Many people who have mortgages are deeply in debt and in a poor position to absorb job losses or home price declines.

Home values vs. debt (in 2008 dollars)		
	1999	2008
Average home price	$194,270	$277,703
Average home debt	$139,176	$219,451
Debt as a % of home value	72%	79%

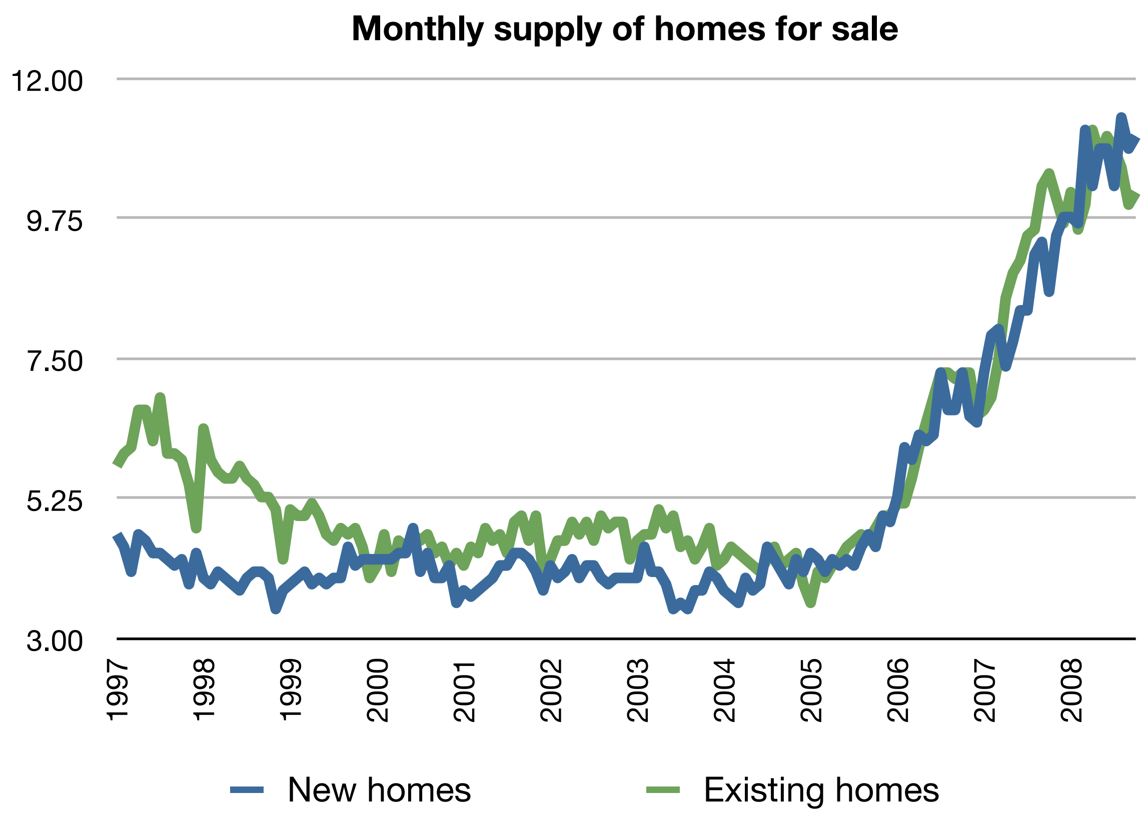
Source: Federal Reserve Board, Census Bureau

Homeowners have bigger homes, bigger mortgages and less home equity than ever.



Source: Mortgage Bankers Association

This is bad news for banks and other mortgage lenders. The value of collateral is precariously low. The pool of qualified borrowers has shrunk dramatically because bigger down payments are required and many homeowners are drowning in debt. One in 10 homeowners are behind on mortgage payments or in foreclosure — a number unheard of since the Great Depression.



Source: National Association of Realtors; Census Bureau

A six-month supply of homes is considered a healthy inventory. The supply of homes for sale is not at record highs. But it has never taken this long to clear out a surplus, especially after prices have fallen sharply.