The Outlook for Recovery in U.S. Real Estate Markets

BY ANTHONY DOWNS, CRE

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In the past, real estate markets have nearly always been a positive force, helping the U.S. economy recover from a recession, especially through rising activity in housing markets. But in this economy, real estate of all types has instead become a drag on our recovery. In fact, current housing market conditions in particular are notably slowing our progress in getting out of trouble.

Real estate was the major force that threw us into this rather deep recession—as compared with most others since World War II. Hence it should not be so surprising that it is not now leading us out. The upshot is that our recovery is proceeding only very slowly, and is likely to remain moving at a snail's pace for several more years to come.

HOW IT ALL STARTED

In reality, Americans are now being forced to adjust their standard of living downward—I believe for a long time—because they had been living far beyond their true ability to sustain their high levels of consumption. From about the mid-1990s through 2007, Americans were consuming far more than they were able to pay for through either savings or investment in productive capacity. Instead, we borrowed tons of money from other nations who were more than eager to support our irrational behavior by exporting to us without getting comparable imports from us in return—only I.O.U.s in the form of U.S. Treasury securities.

So, in this economic boom and bust period, real estate has been the villain both coming and going. It is still

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behaving villainously by impeding our progress back to prosperity. The whole adventure started after housing prices, as a national average, kept rising continuously for 32 years from 1968–2006, though they occasionally declined for awhile in specific areas. That generated a widespread American belief that housing prices would always keep rising, no matter what else was happening in the economy.

The second stimulator of over-emphasis on real estate was the collapse in the U.S. stock market in 2000, when the "Internet bubble" suddenly burst and stock prices plunged. That drove investors the world over away from stocks and toward better investments. For most cash-laden investors, the best alternative in sight was real estate, even though it too had crashed in 1990, at least as far as commercial properties were concerned.

So, capital flooded into real estate markets both in the U.S. and worldwide. It came from inside the nation and from investors the world over. That massive excess of capital created such intense competition among investors looking for "good deals" that their bidding against each other drove property prices up—thus, cap rates down. Such bidding also motivated eager investors to gradually weaken, and eventually, abandon altogether carrying out proper due diligence before committing their funds to specific deals. The old rule that "everything that goes up must come down" was abandoned. But it was still true, as most clearly evident in the behavior of homebuilders. As usual, they kept building as many homes as they could, as fast as they could. They completely ignored the fact that such behavior since World War II had always led to eventual overbuilding and a subsequent fall-off in housing starts and markets. When new housing starts (including manufactured homes) exceeded two million units in both 2004 and 2005, there were not enough buyers to keep the market going, and home prices began to fall. That fall was accelerated by the greedy behavior of the mortgage loan industry. Many of its members, including many banks, had urged and enabled millions of low-income households to buy new homes, by breaking all the normal rules of prudence and legality. They designed, sold and then securitized mortgages for millions of households that would never be able to repay. So, when home prices started to fall in 2006, the entire structure of home lending fell apart. This spread panic among real estate investors around the world, many of whom had bought securitized bonds because they had triple-A ratings from American rating agencies that had also abandoned careful due diligence. The resulting fear of the quality of American real estate securities led to a lending freeze on all types of properties that caused the major crash in 2008 and 2009.

That crash was the worst in the U.S. economy since before World War II—especially in housing markets. New housing starts plunged from a peak of just over two million in 2005 to a low of about 554,000 in 2009—a drop of 73 percent in just four years. That was by far the biggest fall-off in home building since records on starts began to be collected. Moreover, that collapse threw millions of construction workers, mortgage brokers, bank tellers, furniture makers, and other people out of work, leading the way to the largest increase in unemployment in the post-World War II period. Of course, that fall in employed workers spread to other industries as consumer spending took a nosedive, further weakening the possible forces of recovery. Now, with unemployment over nine percent, where are the engines of recovery?

WHY COMMERCIAL REAL ESTATE WILL NOT BE AN ENGINE OF RECOVERY VERY SOON

Commercial real estate is not likely to become one of those engines. More than one trillion dollars in loans on commercial properties will become due in the next few years, but many of the borrowers concerned will be unable to repay them or even just roll them over. Commercial property values have fallen from 25–40 percent since the crash of 2008. Many loans made from 2000–2007 at high loan-to-value ratios of 70–90 percent are now tied to properties worth much less than the mortgage amounts on them alone. In the eight years from 2000–2007, 5.8 times as much commercial property lending was done, as measured in dollars, as in the preceding eight years, mainly because borrowing money was so cheap from 2000–2006. Reckless lenders used securitization to leverage their loans vastly beyond prudent ratios to their reserves. When such loans come due in the next few years, borrowers will discover that their lenders now value the properties concerned at 25–40 percent less than they did when those loans were made. Moreover, lenders no longer accept loan-to-value ratios of much more than 60 percent. Assume you bought a property worth $100 million in 2002 and you borrowed $75 million on a mortgage to get it. When it comes due, the lender will say it is now worth only, say, $70 million, but they will not lend you more than 60 percent of that, or $42 million. So you have to come up with the difference between $70 million and $42 million, or another $28 million, to roll over the loan. Where will you get that amount? What lenders will make such a deal on such a devalued property? Are you willing to add $28 million to the $25 million in presumed equity you already had, for a total of $53 million in equity on a property worth $70 million, at best? In more and more cases, commercial borrowers and owners are choosing to hand the keys back to the lender, if it is a non-recourse loan, and just walk away.

Even considered from the lender's side, the deal is not very attractive. If the borrower cannot come up with the necessary capital, do most lenders want to foreclose and then have to operate such properties? Many lenders today prefer to extend the loan into the future at the same interest rate and monthly payments in hopes that property prices will rise between now and when the loan comes due again. Moreover, until very recently, rent levels and vacancy rates were deteriorating in most commercial property markets. So, foreclosing would stick the lender with a weakening property in a tough market. Conditions have been getting better in some office markets, but there is still not a lot of dynamism anywhere. The upshot is that commercial property markets are not likely to lead to a surging recovery in real estate in the near future.

WHY THE OUTLOOK IN HOUSING MARKETS IS EVEN WORSE

Because of high unemployment, many homeowners who thought they had incomes adequate for carrying their mortgages now find those mortgages under water—that is, with a greater face value than the current market values of their homes—and their incomes falling towards zero. Some mortgage experts estimate that one out of every four homeowners with a mortgage now has a mortgage that is under water. Since about 32.8 percent of homeowners do not have mortgages, the implication is that 16.8 percent of all homeowners—or 12.8 million households—have mortgages under water. Millions have become delinquent in making payments or have simply stopped paying. As a result, foreclosure filings have soared to record levels. RealtyTrac®, a firm that tracks foreclosures, states that the number of foreclosure filings has risen from about 1.0 million in 2006 to 3.9 million in 2009, and will reach about 3.9 million again in 2010. Only about 20–30 percent of filings in any given year result in takeovers or sales by lenders in the same year. But that means approximately 975,000 takeovers or sales will occur in both 2009, 2010 and well into 2011. The present owners of the homes concerned will not soon be in the market to buy other homes, so many will rent.

Overall, sales of existing homes peaked at just over seven million per year in 2005, and have fallen to about five million in 2010, a drop of 29 percent. As of 2008, more than 4.2 million homes were for sale in all of the U.S., according to the National Association of REALTORS® (NAR).

However, the already bad situation in housing markets actually worsened in October 2010. Several major lending banks discovered that many of their mortgages in foreclosure had not been carefully read by their own personnel or by the originators, and could be marred by fraudulent aspects not yet uncovered. Hence those banks have frozen their own foreclosures nationwide while they review millions of documents in those cases. This has caused a semi-paralysis in many housing markets, since many buyers do not know whether the deals they are engaged in will proceed to closure soon.

Another negative factor is the continued declines in home prices in some markets. The Federal Housing Finance Agency (FHFA) seasonally adjusted price index (1991 Q1 = 100) was 136.87 in Q1 2000, and peaked at 220.04 in Q2 2007. That indicates a rise of 60.7 percent in seven years. Since then, it fell to 194.28 in Q2 2010, a decline of 11.8 percent in three years; it was then still 41.9 percent above the 2000 level. The Case-Shiller Home Price Index for 20 metropolitan areas rose from 100 in 2000 to 206.43 in May 2006, a gain of 106.43 percent. It then declined to 147.55 in July 2010, a drop of 28.6 percent in four years. It was still 47.6 percent above its 2000 level. NAR median home price peaked at $221,900 in 2006 and then declined to $178,600 in August 2010, a fall of 19.6 percent in four years. If we average the declines from the peak of the three indices, the result is almost exactly 20 percent. However, home prices are still falling in many regions, though at slower rates than in the last few years. But these data are somewhat distorted because they are based on sales of both foreclosed homes and "normal" homes, and the share of foreclosed homes—which have lower prices than "normal" ones of similar character—has been higher recently than in the past. That has pushed the overall average prices downward significantly.

Another factor of importance is that population growth rates have slowed over the past two years, according to preliminary data developed by William Frey from the 2010 Census. In the period from 2000–2007, population grew by two percent or slightly more per year in the exurban portions of metropolitan areas; by approximately 1.8–1.96 percent per year in the suburban portions; and by approximately 0.8 percent in urban areas (central cities). But in 2009, growth rates fell to 0.45 percent in urban areas, 1.4 percent in suburbs, and only 1.15 percent in exurbs. It appears that we cannot count on a backlog of unsatisfied home seekers to expand the demand for new housing—at least not in the immediate future.

WHAT DOES IT ALL MEAN?

Looking at all of these characteristics of the home market together, we are forced to conclude that a return to "normal" housing markets not dominated by foreclosures is still several years away. The key factor is the speed at which unemployment is replaced by jobs that will enable more households to afford to buy homes. In the meantime, rental housing seems to be more favored than ownership housing because of the limited ability of households to amass enough money to buy a home. That is undoubtedly why apartments are doing better than single-family homes in today's markets.

True, some other parts of the U.S. economy are doing much better than real estate. Farming is booming because of a sharp rise around the world in food prices. The high-tech world is showing some signs of recovery. And ironically, banks—especially big ones—are making enough money these days to return to paying high salaries and bonuses, though smaller payoffs than earlier in this decade. So the failure of real estate to carry much of the load of a strong recovery does not mean the economy is doomed.

But it does mean that people in the real estate business had better prepare for at least a few more years of sub-optimal prosperity. And perhaps conditions in real estate will never return to "normal"—if that word means "conditions that prevailed in 2007." The nation was living beyond its means then, especially in real estate. We need to become reconciled to achieving a more sustainable balance between what we consume and what we produce. This is most obvious in our federal and state budgets, but applies to our own production and consumption in the private sector as well. ■