TD Economics

Special Report

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A LOOK AT U.S. HOME PRICES FROM 2002 TO NOW – THE CORRECTION ISN'T OVER

The collapse of the U.S. housing market is now well into its third year and continues to hold U.S. economic growth hostage. Every month new housing statistics keep media attention focused on the most recent decline in U.S. home prices, reminding households that one of their most important assets continues to depreciate in value. Amidst all the attention to the recent fall in home prices, it is often forgotten that the drop in prices followed tremendous run-ups from 2002 until mid-2006 so that in nominal terms there is still a sizeable net gain in home values over this period. Moreover, with all the focus on the national number, the headlines sometimes miss that there remains a significant regional element to recent house price declines. In this report we examine the performance of house prices in the 20 major cities covered by the S&P/Case-Shiller home price index over the period extending from 2002 to the present. Doing so is useful for several reasons. First, it highlights that the current level of home prices is not particularly low – in aggregate we've just rewound prices to mid-2004 in nominal terms. Second, flowing from this first point, it raises the prospect for prices to fall further. Third, it sheds some light on the balance sheet implications for households depending upon when and where they purchased their home. Not surprisingly perhaps, cities that saw the highest increases in home prices earlier in the cycle are now those experiencing the biggest drops.

HIGHLIGHTS

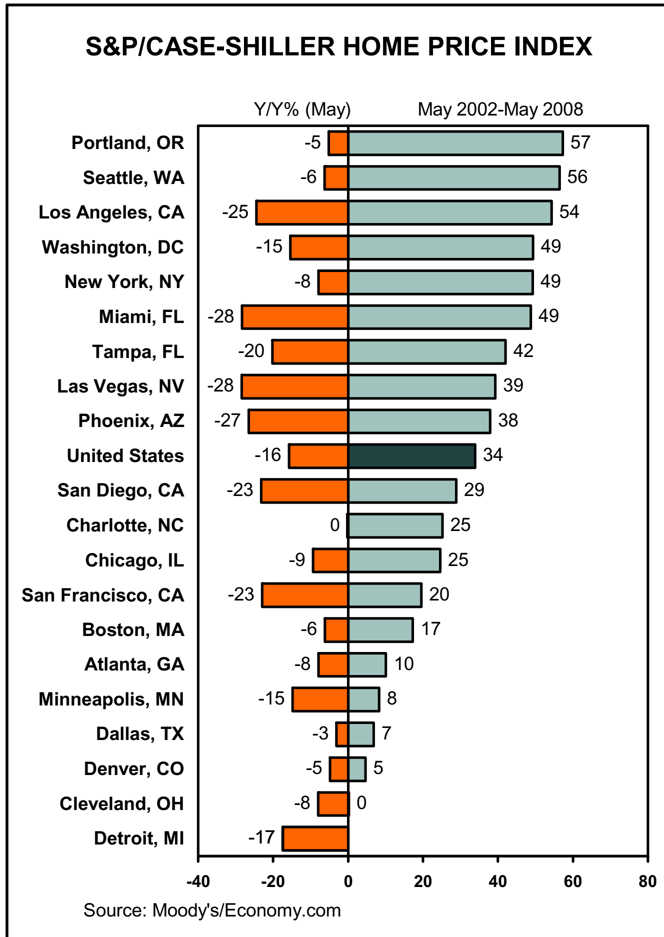
- **Home prices across the U.S. have fallen considerably in the last year, a fact reflected in the 16% drop in the S&P Case/Shiller home price index since last May.**
- **But this fall in prices was preceded by tremendous gains earlier during the housing boom. Since May 2002 the national S&P Case/Shiller home price index is still up 34% in nominal terms and 10% in real terms.**
- **Prices likely still have some way to adjust downward with cities such as Los Angeles, Las Vegas, and Miami which saw the largest price gains, likely to continue to see outsized losses going forward.**

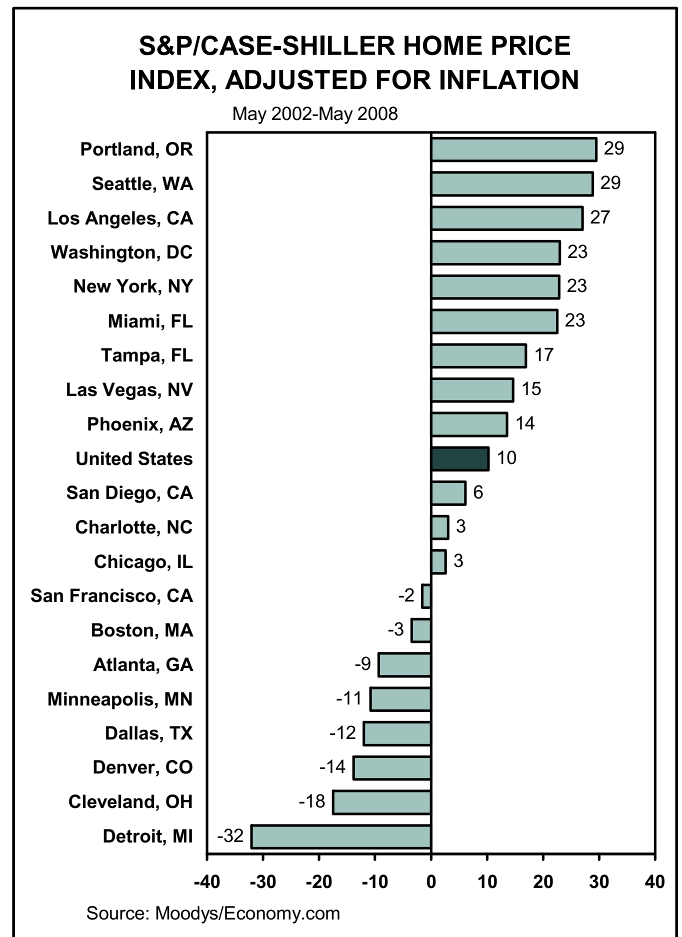
2002 – The beginning of the boom

As homeowners tend to stay in their homes significantly longer than one year it makes sense to take a longer-term perspective to the change in home prices.[1] The current housing boom had its beginnings in the aftermath of the 2001 economic recession. By 2002, house prices were increasing at a healthy rate but had not yet reached the double-digit surge in prices that came in 2004 and 2005. 2002 is generally deemed to be the start of the housing boom and is a good point to begin our analysis. Mortgage rates were falling to historic lows and were held at a low level for another 2 years, sparking an influx of home demand and acceleration in home prices. The housing market was also relatively balanced. Single family home inventories averaged 4.7 month's supply, slightly higher than the previous two years, which averaged 4.5 months. A balanced market looks to be in the 5.0 to 5.5 month range.

Nominal price gains are still solid

Looking at the change in home prices from 2002 to the present we find that homeowners in most major cities who bought early in the housing boom are still benefitting from an appreciation in real estate worth. Nominal prices in aggregate are up a cumulative 34% from May 2002 to May 2008. Miami and Los Angeles stick out particularly as cities which despite having seen striking falls in nominal





house prices over the last year are still up considerably on a longer-term basis. In both cities nominal values are up close to 50% since May 2002 despite declining by more than 25% in the past year. This contrasts with cities like Dallas and Denver, which although down less than 5% from a year-ago are up by only 5% since 2002. By far the best performers of the bunch are Seattle and Portland with price gains of close to 60% since 2002. Unfortunately, there is at least one exception to the rule that higher house price gains earlier lead to worse drops in the current period. In Detroit, year-over-year gains in nominal house prices never topped 5%, yet prices over the last year are down close to 20%. Clearly, local economic conditions added to the impact of the collapse in home values related to the fallout from subprime mortgages, resulting in home prices that are down 17% from their values in 2002.

But real price gains less so…

Unfortunately, the picture looks less favorable when inflation is stripped away. The good news is that real home prices are up a cumulative 10% since 2002, with substantial gains in the range of 23-27% in the cities of Los Angeles, Washington D.C, and Miami. These cities were among those deemed most exposed to subprime mortgages and over-building, and clearly some homeowners are still coming out ahead in the midst of the current housing recession. But, from a portfolio standpoint, a 10% real gain (nationally) over 6 years averages to a 1.6% annual gain, which isn't a great return on assets, especially given that this rate of return does not take into consideration a homeowner's expense of property taxes and maintenance. As a basis of comparison, the average yield on 10-year TIPs issued in 2002 (10-Year Treasury Inflation Adjusted Note Due 7/15/12) is 1.84%. The picture darkens further when you consider that most homeowners who bought in 2004 or later are out-of-the-money on their homes. From May 2004 to May 2008, real prices in 16 of the 20 major metro markets are in the red, and two of the remaining cities are barely positive. The exceptions are Seattle and Portland, which have seen a cumulative real price gain of about 20% each. Seattle and Portland were both late arrivals to the house price booms taking place in the rest of the country.

Price growth peaked in these north-western cites almost two years after the rest of the country in 2006 instead of 2004. Price growth has decelerated similarly to other cities but their later arrival has made these markets better performers over the later time period.

Bottom Line

Hind-sight being 20-20 it is now clear that the house price gains that occurred late in the housing cycle overshot fundamentals and are now in the process of correcting to a more sustainable level. 2002 serves as a good benchmark for the performance of the U.S. housing market under more balanced conditions and is a likely candidate for where prices might be expected to return to once the excess returns of the late housing boom have worked themselves off. Indeed, with an 11 month supply glut currently sitting on the market alongside expectations of weak employment and income growth over the next four quarters, it is conceivable that there could be an overshoot on the price adjustment. A further 5 percent nominal price decline would take the overall retrenchment of prices since the peak of 2006 from the 18.4 percent recorded in May of this year to 22.5 percent. Expressed in this manner the price adjustment appears staggering. However, assuming consumer price inflation (excluding shelter) close to 5 percent over the next year, this 5 percent further decline in nominal home prices would bring the national home price just 1% percent below the real level of 2002. In this longer-term context an assumption of such a further price decline does not appear heroic in the least.

From a regional perspective, it is interesting to note that of the nine cities which have seen cumulative gains above the 10% national average, five of them – Los Angeles, Miami, Tampa, Las Vegas and Phoenix – are now experiencing year-over-year declines in excess of the national average. Given that these markets were the most inflated before the crash in prices it should be expected that they have the farthest to go before coming back into balance. While the housing market may be close to a bottom in terms of home sales, recent evidence suggests that significant declines in house prices are necessary to drawdown the supply of unsold homes in the most inflated markets. According to data from the California Realtors Association, the month's supply of existing homes in Los Angeles fell to 9.1 in May from a peak of 20 months in October of last year but this was accompanied by a downward move in year-over-year prices from -4% to -24% over the same period. While changes in existing home prices are not directly comparable with the Case-Shiller data as they reflect the current mix of homes for sale (and have thus likely been brought down by forced sales of foreclosures), this suggests that cities like Los Angeles, Las Vegas and Miami where price growth was most excessive, will continue to be those cities where price declines will be the greatest.

National S&P/Case-Shiller Home Price Index
May 2008

Percent change	Nominal	Real
Relative to:		
May 2002	33.9	10.3
Mid-2004	0.7	-9.8
Peak of Mid-2006	-18.4	-24.4

Source: Economy.com,TD Economics

National S&P/Case-Shiller Home Price Index
With a further 5% nominal decline

Percent change	Nominal	Real
Relative to:		
May 2002	27.2	-1.0
Mid-2004	-4.4	-21.8
Peak of Mid-2006	-22.5	-32.2

Source: Economy.com, TD Economics

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Endnotes

[1] According to the Census Bureau the median duration of tenure in the U.S. in the mid 1990s was 4.8 years.

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