NEWS ANALYSIS

By Amey Stone

Why Housing Could Spring a Leak

The risks that this so-far stalwart market could turn for the worse are starting to rise -- along with interest rates

It sure looked like good news: On Apr. 2, the government announced that a stunning 308,000 new jobs were created in March (economists were expecting only about 130,000). For the housing market, however, these tidings hit like a ton of bricks. Almost immediately, interest rates started rising, and housing stocks started falling.

KB Homes (KBH) fell from $80.20 to $76.60 that day and to $75.27 the next (see BW Online, 4/5/04, "KB Home: Cyclical No Longer?"). D.H Horton (DHI), Lennar (LEN), and Centex (CTX) all slumped an average of about 7% those two days before rebounding a bit on Apr. 6.

Are these stocks signaling potential weakness ahead for real estate? You bet they are. While housing experts point to myriad reasons why the real estate market will likely stay robust through 2004, the risk of a serious downturn in the next few years is clearly increasing -- particularly in areas of the country where home prices have risen the most.

"AN ATTRACTIVE ZONE." So far, the interest rate jumps have been moderate. Rates for traditional 30-year mortgages remain way below their historical average of around 8%. But on Apr. 6, Bankrate.com's overnight survey of lenders showed the average rate on a 30-year-fixed mortgage spiked to 5.48%, up from 5.2% a week earlier.

"It's hard to be too concerned about such a relatively small backup," notes Mike Sklarz, chief valuation officer for real estate services company Fidelity National Financial in Jacksonville, Fla. "We're still in such an attractive zone of interest rates." He believes rates would have to rise to 6.5% or 7% to hurt the market.

That kind of a rise doesn't seem likely this year. Indeed, rates briefly climbed above 6% last August, only to retreat quickly when the economy slowed in the fourth quarter. But through it all, sales volume and home-price appreciation nationally have never slumped. And if the economy continues to grow and inflation perks up, a housing market bubble is certainly a plausible scenario a year or two from now.

THE AFFORDABILITY QUESTION. Any downturn in the market could have major economic ramifications. With home ownership now up to almost 70% of households, Americans are pouring more and more of their savings -- as well as their hopes and dreams -- into their homes. "You can't ignore the fact that low interest rates haves aided affordability and to some extent deserve credit for continued rapid price appreciation in real estate prices over the year," says Greg McBride, financial analyst at Bankrate.com.

It's people's ability to afford a high-priced home that is directly affected when rates rise, not the actual home price. For now, buyers are turning to adjustable-rate mortgages (ARMs) to find the same interest rate they could once get through a 30-year fixed, says Paul Fine, senior vice-president at GMAC Mortgage. ARMs provide buyers with a lower rate now, in exchange for lenders gaining the option of raising the rate at a set point in the future.

The increasing popularity of ARMs is likely to keep the housing market strong through this year, says Frank Anton, president of Hanley Wood, a Washington (D.C.)-based media company that serves the residential-construction industry. The problem is that ARMs put homeowners at risk of being unable to afford their home in the future if interest rates rise substantially over the next few years (see BW, 4/12/04, "Home Buyers: ARMed And Dangerous?").

Here's a worst case scenario: Today's buyer of a $500,000 home finds that in three years she owes that same amount, but has to pay twice as much to finance it, while she can sell the house for only $300,000. It doesn't take much imagination to see what such a trend would do to the banking industry, consumer confidence, and the broader economy.

SUPPLY-DEMAND CUSHION. So far, that kind of doomsday appears far fetched, housing experts say. They expect home prices to level off at some point in the future, but not tumble. While regional home values can and often do rise and fall, average home prices nationwide haven't dropped in about 35 years of record-keeping.

Plus, housing inventory remains near record lows, and supply is hard to add in areas where prices are rising fastest, says Craig Kucera, who covers homebuilding stocks for brokerage firm Friedman Billings Ramsey. "We still have a significant supply-demand imbalance," he says. "That adds some cushion if there's a slowdown in 2005 or later this year, but I don't see that."

Plus, if rates continue to rise (which isn't a given), that will likely be because the economy is improving, which means personal incomes will be rising, and more people will be able to afford higher-priced homes, Anton says. Even in a rising-rate environment, "it's conceivable that the housing market would move ahead with barely a blip," he adds.

WARNING SIGNS. None of this means that stable real estate values are etched in stone, however. The country is already dotted with pockets of vulnerability. In parts of California such as Silicon Valley, average prices have climbed beyond the affordable range for the typical income-earner. Sklarz points to places like Key Biscayne (Fla.) and South Hampton (N.Y.), where prices have risen the fastest, as potential trouble spots. It's "a pretty good signal" of vulnerability, he says, if prices have gone up more than 150% in the past five years.

Worried about your neighborhood? Watch the local listings for a growing inventory of homes on the market and flattening or falling prices at the high end. That's a leading indicator for the rest of the market, says Sklarz. Keep your ears open for signs of speculation: Is your neighbor buying a house with plans to fix it up and flip it?

Kucera also looks at the rental market, which is weakening on a national level, as a gauge of home-price appreciation potential. If you can rent a comparable home for much less than it would cost to buy it, that's a worrisome sign.

Also, keep an eye on those homebuilding stocks. For now, Wall Street is signaling only more risk, not the reality of a weakening housing market. Luckily, houses aren't like stocks, which are a lot easier to trade. But as mortgage rates rise, fewer people will be able to afford to move up to a nicer house. That's a trend today's home buyers need to keep in mind, even if any weakening in the housing market is still years away.

Stone is a senior writer at BusinessWeek Online and covers the markets as a Street Wise columnist
Edited by Douglas Harbrecht

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