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THE JOURNAL REPORT: HOME INVESTMENTS

The New Housing Market -- And How to Make the Most of It

Baby boomers are aging. Interest rates are rising. Land-use regulations are getting tighter. What's a home investor to do?

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It's been a great run.

In the past five years, home prices nationwide have climbed an average of more than 40%, according to one popular measure -- and more than 75% in some areas, including Boston, suburban New York and San Diego. Homeowners have tapped that equity to take vacations, buy second homes and build up their nest eggs. They have counted on rising home prices to bolster their future -- and shore up their present.

But now homeowners have to face a new reality: The party can't last forever.

THE JOURNAL REPORT

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Go Figure: Interest rates on ARMs are moving closer to those on fixed-rate mortgages.

State of the Market: Amid fears of rising mortgage rates, home shoppers who had been sitting on the fence are now rushing to buy before rates go higher. See an interactive map of the nation's housing market.

Over the next five or 10 years, analysts say, home prices are likely to yield a less-impressive return, while the market slows to catch its breath.

For home buyers, that prospect presents a new set of challenges. In the recent past, diving into real estate was a no-brainer: Interest rates were low, and there were precious few other ways to safely invest money. It was hard to go wrong -- no matter where you bought a home.

Now, some of the forces that made housing so attractive have faded. The stock market has improved, and home-price appreciation has slowed across the country.

The good news is that few economists believe the housing market is about to crater. On the contrary, the available evidence suggests that home prices will continue to appreciate in most cities, although at a slower pace than before. Michael Sklarz, a widely followed home-price analyst in Honolulu, says that over the long haul, home prices on a national basis invariably rise at a pace slightly faster than inflation. Even so, with home values having run well ahead of inflation in recent years, he predicts that prices will rise only half as much in the next decade as they did in the past one.

That doesn't mean it will be impossible to make a good investment in real estate. It just means it will take a lot more work to do so. Here's a look at some of the economic and demographic forces that will drive the housing market in coming years, and how you can navigate them to your advantage.

Income Growth

From 1980 to 2001, median incomes in the U.S. rose 138%. Home prices rose almost exactly the same amount: 136%. A coincidence? Hardly. Over time, home prices move in lockstep with incomes, because incomes help determine how much a consumer can spend on a home. The relationship isn't always so clear in the short term, as builders add more supply if demand rises, and hold back if demand falls. But in general, if home prices grow faster than incomes, houses will then become unaffordable, and that will force a slowdown in price appreciation until the market balances out.

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That's what homeowners could face in the next several years. From 1996 to 2003, incomes rose 22%, while home prices climbed 47%. In some cities, the gap was even wider. In Boston, for example, incomes rose 40%, while home prices shot up 120%. In San Diego, incomes rose just 31%, compared with a 142% run-up in home values.

Low interest rates have helped mask the problem by lowering home buyers' monthly mortgage payments. But sooner or later, incomes will have to catch up, especially if interest rates rise.

What should home buyers do in the face of an income gap? If you're a short-term investor with plans to buy a home and sell it again in a year or two, you should steer away from cities where the gap between incomes and prices is widest. That includes many cities in the Northeast and in California, which could face more harsh corrections in the short run.

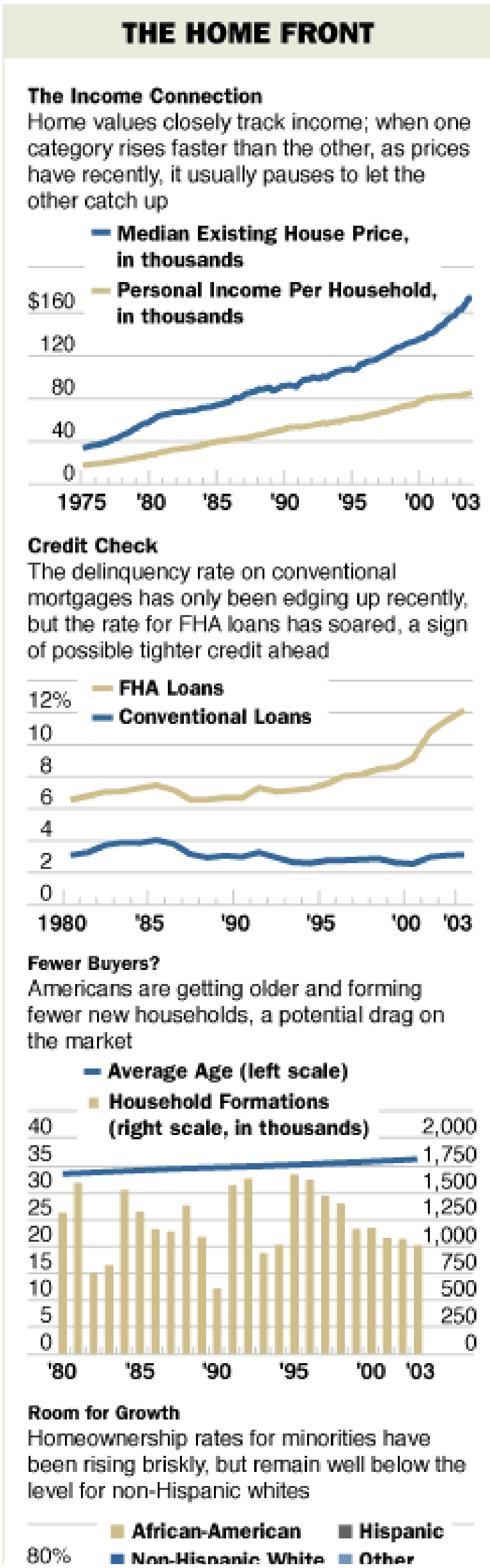
But if you're looking to hold onto a house for many years, the Northeast and California often are smart places to buy. Even though their price-to-income ratios are out of whack now, many cities in those areas tend to have fast income growth over the long haul. The same is also true of many Sunbelt cities, like Atlanta. That means their prices will have more room to rise over a long stretch of time.

This doesn't mean you should necessarily target neighborhoods that have high average incomes. What matters is the rate at which the incomes are rising, not the amount of wealth that's already there. After all, income growth can easily stagnate in posh parts of town when an economy goes south. Often, the best investments are made in transitional neighborhoods that once were economically distressed but are now enjoying rapid income gains due to new investments -- and new jobs -- in the area.

Interest Rates

Perhaps no other factor has pushed home sales and home prices higher in the past decade than the long-term decline in interest rates. Consider: In 1981, the interest rate for a 30-year, fixed-rate loan averaged 16.63%. The monthly payment for a $200,000 mortgage at that rate was $2,800 a month. Today, the average rate is about 6.25%. For the same $200,000 loan, that translates into payments of less than $1,250 a month. It should hardly be a surprise, then, that Americans bought more than one million new homes last year, up from just 436,000 in 1981.

The problem now is that interest rates are more likely to rise than fall. The economy is rebounding, inflationary pressures are beginning to appear, and the federal budget deficit is growing. All of these forces suggest rates will climb over the next few years.



Of course, no one expects rates to return to anything remotely close to the levels seen in the 1980s. But even a slight rise in interest rates could knock some buyers out of the market. If rates go to 7%, that would add $1,000 or more annually in payments on a $200,000 loan.

Also, as interest rates rise, more Americans will likely choose to rent their homes rather than buy. Because so many people bought homes in recent years, there is a now a large surplus of apartment units, and their owners are eager to deal. As more families take advantage of those deals, housing could slow further.

Real-estate agents will tell you that a rise in interest rates will be offset by an improved economy, which should inspire more buyer confidence -- and more home sales. That may be true, but only to a point. As the recent business cycle proved, housing can rise to new heights during a downturn, and it needn't boom during an economic rebound. Prices were nearly flat during the first several years of the rebound in the 1990s.

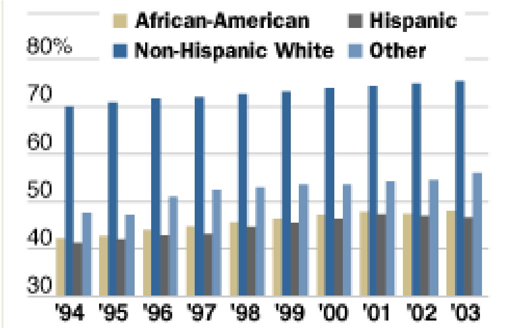
For buyers, one way to mitigate the pain of higher rates is to apply for an adjustable-rate loan that starts with an unusually low rate, then adjusts higher later if interest rates keep climbing. But that increases your risk later. For investors, it's worth noting that properties in affluent neighborhoods tend to be less vulnerable to rate increases, since wealthier buyers can more easily afford higher interest costs.

Then again, if you're not set on owning a home right away, you might just want to wait -- and rent. True, you'll be missing out on the current low interest rates. But you'll probably get a good deal from your landlord, and save yourself the headaches of worrying about you home's value when rates rise. You can always buy later, and then refinance the mortgage once interest rates come down again.

An Aging Population

In 1970, the median age in the U.S. was 27.9. Today, it's 35.5.

Real-estate agents often say this is good news for housing. The older a person is, the thinking goes, the more likely he or she is to own a home. So as America ages, there should be



Sources: National Association of Realtors; Bureau of Economic Analysis; Census Bureau; Mortgage Bankers Association; Freddie Mac; Economy.com

more home sales.

Unfortunately, that's not necessarily the case. Older Americans are less likely to move than younger people, and they don't form new households that didn't exist before. In the 1970s, the number of new households formed each year -- a key indicator of housing demand -- soared to 1.67 million. In this decade, as America gets older, household formation is expected to sag to an annual average of 1.27 million.

The good news is that the potential drag from an aging population is probably less of a factor now than in previous generations. Indeed, some analysts even believe older Americans will be a net positive for housing in this decade. People in their 40s, 50s and 60s today are wealthier than their predecessors, and healthier. So they're more likely to buy second homes. They're also more likely to move to new, often smaller, homes when their children move out.

For investors, the best way to benefit from an aging population is to think about buying in areas that will benefit from baby boomers' migratory patterns. Popular locales for retirees, including Florida, Texas and Arizona, should all get boosts from retiring Americans. States that are less popular among seniors, including Rust Belt states like Ohio, could suffer. Meanwhile, certain houses -- even in the top retiree states -- could become harder to sell. The giant McMansions so popular today could become more difficult to unload a decade from now, as baby boomers downsize into smaller homes.

You might also consider buying a home in one of the growing number of "active adult" communities around the country that cater to older buyers. These include the well-known Sun City and similar developments in Arizona, Texas and elsewhere that offer golf courses, community centers and other amenities for young retirees.

Meanwhile, if you're planning to fix up your home, ask an architect for tips about ways to make the house more accessible for older buyers. Some architects specialize in "aging in place" designs that allow older owners to live in homes longer by reducing clutter, widening passageways and adding grab bars and railings. If you're trying to target an older buyer, some of these modifications can greatly increase your home's value.

Of course, a decade from now all of this might not matter: By then, the children of the baby boomers, known as the echo boomers, will be coming of age as home buyers. When that happens, household formation should pick up substantially.

Immigration Trends

One reason an aging population didn't hurt housing in the 1990s is that immigrant and minority home buyers barreled into the market as never before. In the 1990s, more than nine million people immigrated to the U.S., compared with an average of 3.3 million a decade in the 1950s, '60s and '70s. Many of those immigrants ultimately bought homes, offsetting the loss of demand from an aging population. Meanwhile, an ever-larger number of minority home buyers bought homes in the 1990s with the help of new mortgage programs created by quasigovernmental agencies Fannie Mae and Freddie Mac.

Can the boost from immigrant and minority buyers continue? Many analysts believe it will. For one thing, the homeownership rate for African-Americans is 49.3%, far lower than the 75.5% rate for non-Hispanic whites. That implies there's a lot of room for minority homeownership to grow.

Even if immigration slows in the coming years, the market should continue to get a boost from those who entered the U.S. in the 1980s and 1990s. Most immigrants don't buy their first homes until they've been in the U.S. at least five years, and often even longer, meaning that the full impact of the 1990s immigration surge hasn't even been felt yet.

Investors who want to benefit from rising immigration rates should target transitional neighborhoods with large immigrant populations. Often, this will require focusing on fixer-upper properties that can be bought at a reduced price and then rented out while the neighborhood's income levels rise. Such properties can be more difficult to manage, but they often provide a steady income stream and above-average appreciation.

It will also be necessary to familiarize yourself with the latest mortgage products for first-time buyers, as well as any mortgage brokers and real-estate agents nearby who specialize in working with immigrant buyers. They can be ambassadors of sorts to help you better understand the nuances of dealing with immigrant buyers, many of whom might not speak English or understand the ins and outs of the U.S. mortgage-finance system.

But investors should be wary of some risks. If interest rates climb significantly, first-time home buyers -- including many immigrant families -- would be among the hardest-hit. It's also possible that lenders could reduce the availability of credit to these borrowers if a recent rise in delinquencies for certain loans continues.

Availability of Credit

Dramatic changes in the mortgage market during the past 10 years made it easier for borrowers to get home loans. Using sophisticated risk models, lenders were able to offer credit to borrowers with lower down payments and higher debt levels. At the same time, advances in loan-processing technology made the loan-approval process easier, faster and less expensive.

One big question is whether these innovations will continue to fuel expansion of mortgage credit in the current decade. If they do, it will make it easier for banks to approve more minorities, immigrant families and lower-income Americans, creating a vastly larger pool of potential buyers.

But many economists worry that the mortgage-credit system may already be stretched to its limit. In addition to higher delinquencies for many first-time home buyers, debt burdens in the U.S. are now significantly higher than a decade ago. Household debt as a percentage of disposable personal income rose to 118.8% in 2003 from 86.8% in 1990.

Also, underwriting guidelines are very loose by historical standards. Banks these days often let home buyers get loans when their mortgage payments total as much as 50% of their monthly income, up from the more customary limit of about one-third in past cycles. Lenders probably won't be able to push the current limit much further, and they could reverse course if delinquencies rise, as some expect.

Investors should pay close attention to quarterly mortgage delinquency data from the Mortgage Bankers Association. Although delinquencies for some kinds of mortgages have improved over the past year, significant patches of bad credit remain, especially among first-time home buyers. If overall mortgage delinquencies creep up further, that could be a sign that more credit tightening is coming -- with negative consequences for housing investments.

Investors should also seek to avoid geographic areas with unusually high levels of defaults. Recently this has included places that were hit hard by the manufacturing recession, including parts of Ohio, Michigan and North Carolina. It also includes cities that were smacked by the technology and telecom bubbles, including parts of Dallas and Denver.

It's worth noting that even high-income neighborhoods can have high levels of defaults -- if there have been lots of layoffs in the area. Investors can learn more about the credit quality in their area by talking with a mortgage lender and tracking down data on recent layoffs in the region.

Housing Supply

In recent years it has become harder and harder for builders to develop large housing projects. In some places, like San Francisco, there simply isn't much land left. In other places, such as Portland, environmental concerns have spurred local leaders to create strict land-use restrictions that keep a lid on new supply.

Partly as a result, the U.S. currently has a tight 4.6-month supply of existing homes for sale, according to the National Association of Realtors. That means that if no houses are added to the market, and sales activity continues at its current pace, the U.S. would run out of existing homes for sale this fall. At the beginning of the last decade, the inventory of homes reached as high as 9.6 months.

Less supply tends to push prices higher over the long haul. Compare home prices in places like New York, San Francisco and Portland -- all of which face land constraints -- to cities like Houston, Atlanta and Phoenix -- where land is readily available and it's easier for builders to get new projects approved. The median price right now in New York is $369,700. The median price in Houston is $130,700.

Unfortunately, areas with tight supply also tend to have more volatile markets, meaning that prices can shoot up more rapidly during periods of high demand and slow or fall more during periods of weak activity. In areas like Phoenix, where new supply keeps prices from rising too fast, home values have less need to correct whenever the market slows.

It pays to buy homes in areas where it's difficult to add new supply -- so long as you can stomach a more volatile market. If you're looking to buy a home for just a couple of years, you'll need to be more careful in cities like New York and San Francisco, where prices have risen so dramatically in recent years. But if you plan to hold on to a property for a long period of time, especially a decade or more, you're likely to do a lot better in cities with building constraints than in Atlanta, Phoenix or Houston.

It's worth checking with your local city planning department to learn more about the building constraints that exist in your area, including rules governing lot size and population density. You'll also want to inquire about any zoning rules that could attract other kinds of development to the neighborhood that could reduce your property's value, including industrial buildings or high-traffic retail outlets.

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