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Housing market sturdy but vulnerable

By Thomas A. Fogarty, USA TODAY

Home sales surged in July to a record, but economists increasingly are concerned that housing's decade-long bull market may be cresting.

A sign at a Park Ridge, Ill., home shows how the housing market is changing.

By Tim Boyle, Getty Images

Existing homes sold at an annualized rate of 6.12 million last month, eclipsing the previous record of 5.94 million in December and January, the National Association of Realtors reported Monday. Median price — the sales midpoint — skyrocketed to $182,100, up 12.1% from a year earlier and the largest jump since 1980.

But higher interest rates, an uncertain labor market, easy mortgage credit and the long period of hyperactivity have many alarmed about where the market may head.

Part of the glitzy July numbers may be explained by "fence jumpers" — procrastinating shoppers pushed to action by a sharp increase in interest rates since June, says NAR chief economist David Lereah. The better explanation, he says, is a fundamentally sound market fueled by a lean inventory of homes for sale and strong demand from a growing number of households.

Others are less certain. "Numbers for July represent kind of a last hurrah," says Ken Goldstein, economist at the New York-based Conference Board. He foresees a cooling market but says, "Unless someone can demonstrate investing in one's home is suddenly unattractive, housing is not going down for the count." (**Related**: New-home sales rate slips in July).

The analysis is bleaker at money manager Bridgewater Associates. The firm last week told clients to expect a 10% decline in home sales and prices. Higher interest rates and surging prices are putting homes out of the reach of some buyers, the company says. According to Bridgewater, rising interest rates are already undermining housing. But damage won't be apparent in backward-looking monthly housing statistics

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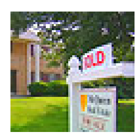

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for a few months.

Caution ahead

The new NAR report is the latest in a series of indicators suggesting remarkable strength in the housing market.

Last week, the government said the annualized rate of housing starts in July rose to 1.87 million units, the strongest number in 17 years.

Earlier this month, NAR reported that all 126 local markets it tracks showed year-over-year increases during the April-June quarter. It's the first time that's happened since surveying began in 1982. In addition, nearly one-third of the metro areas experienced double-digit price growth, NAR said.

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But those readings measure the market as it existed when mortgage rates were at or near 40-year lows.

Forward-looking indicators show cause for concern. Applications for mortgages to purchase homes have fallen 15% over the last two weeks, says the Mortgage Bankers Association of America. And building permits for new homes dipped slightly last month, the Census Bureau reported.

In addition, some of the markets where housing sizzled most are cooling.

Steve Kropper, housing analyst and founder of realty Web site Domania, found that in shopping for his own house in suburban Boston, actual prices have dropped to about 98% of the seller's asking price. At the market's most frenzied, actual prices in the red-hot Boston area typically exceeded what the owner was asking by 3% or more. " 'Crazy' ended here nine months ago," he says.

Elsewhere in Massachusetts, Worcester realty broker William Kelleher says average time on the market for a house has increased to 63 days from 57 days a year ago. Prices continue to rise on declining sales volume, he says.

"The seller's reign has weakened slightly, but there's not been a dramatic shift in market conditions," says Kelleher.

Here's what's worrying analysts:

•**Interest rates.** Since June, the average interest rate on a 30-year fixed-rate mortgage has jumped 1.07 percentage points to 6.28%, says mortgage investor Freddie Mac. Still low by historical standards, the latest interest rate spike is the sharpest over a nine-week period since spring 1994.

The interest rate increase knocks some potential buyers out of the market and reins in the bidding of others. As a result, housing industry economists are lowering their expectations for the rate of price growth later this year.

Economists say damage to the housing market, if any, will depend on whether rates stall or continue higher. Economic consultant John Tuccillo of Arlington, Va., looks for another full-point rise. As a result, he says, "Housing will slow dramatically and stop dead in some markets."

Christopher Cagan, research director at First American Real Estate in Anaheim, Calif., sees only a slight impact from rising interest rates.

"Interest rates are still at historic lows — just 25-year lows instead of 45-year lows," says Cagan.

And innovations by mortgage lenders give borrowers greater ability to minimize the impact of an interest rate spike through adjustable-rate mortgages and other new products.

Karen Davis, a sales manager from Novi, Mich., is buying a place near her current home. The availability of the right house on a quieter street prompted the decision to act despite rising interest rates.

Davis says she was able to blunt the effect of rising rates by taking a mortgage that permits interest-only payments for the first five years. Her savings over a standard 30-year fixed-rate mortgage: $675 a month. Some of that savings will go to monthly payments against the loan principal, even though the lender doesn't require it, Davis says.

•**Forward buying.** Thirty million homes have sold in the past five years, vs. 20 million in the five years ended in 1994. Total home sales have set records in nine of the past 11 years.

Conditions have been so conducive to home buying, says University of North Texas finance professor Randy Guttery, that buyers who prefer to wait buy now instead to head off higher costs in the future.

By "borrowing" against future sales, some analysts say that the housing market may be setting up for a sharper correction. Instead of pent-up demand, says Economy.com chief economist Mark Zandi, "We'll be having spent-up demand."

•**Jobs.** The economy appears to be improving. In fact, that perception is forcing the rise in mortgage interest rates as bond investors, who supply the capital for home finance, adjust expectations. But against the backdrop of general growth, the economy continues to shed jobs. The 44,000 jobs lost in July marked the sixth consecutive month of declining employment.

Michael Sklarz, chief valuation officer at Santa Barbara, Calif.-based FNIS, says continued softness in the labor market could undercut housing by diminishing consumer confidence. Says Sklarz: "Potential home buyers need to feel secure. The job market, rather than mortgage rates, may be the most important factor to watch."

•**Credit standards.** Credit standards have eased over the past decade, as lenders permit smaller down payments and easier terms, such as interest-only monthly payments. And millions of homeowners have tapped into their growing home equity through second mortgages or by taking extra cash when refinancing.

Tuccillo, the Virginia consultant, says years of homeowners supporting themselves "by looting the equity in their homes" puts many in financial peril. That, he and others say, could unleash a flood of market-depressing foreclosures.

John Burns, an Anaheim consultant to home builders, says aggressive lending practices "are creating homeowners who can't afford to pay the mortgage." Damage, he says, is likely to be the worst in neighborhoods where highly leveraged buyers begin losing their homes to foreclosure. Even a slight decline in home values could prompt such a wave, he says.

Zandi of Economy.com also sees a threat from changing credit standards but not the same one. Zandi says he is more concerned about the possibility of a severe constriction of lending requirements if home prices stall or decline. Severely restricted credit could lead to a downward spiral in home values, he says.

Even now, Zandi says, lenders' concerns about inflated home prices have prompted a slight throttling back on mortgage credit.

Market watchers don't have long to wait for new grist for analysis. The Census Bureau is scheduled this morning to release its report on the sale of new homes in July. July sales are expected to roughly match the record-high annualized 1.16 million pace of June, according to Thomson Financial.