Slow Economy May Dim Luxury-Home Prices

By **PATRICK BARTA**
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Question: Do changes in the housing market affect prices of expensive homes (say, homes priced above $1 million) more than less-expensive houses? Specifically, if mortgage rates go up over the next several years, and the housing market slows, are expensive homes going to be more vulnerable to a downturn in prices?

-- *Richard, no location provided*

Richard: There are two schools of thought on this question.

One is that high-end homes perform better during a weak housing market because higher-income families are often better able to maintain their spending patterns during times of economic stress, meaning there's a better chance they'll keep buying and selling houses than lower-income families. The other school of thought, somewhat paradoxically, is that prices for giant houses fall harder during a weak market, in part because expensive homes are considered a luxury, and families try to cut back on luxury items during tough times.

Actually, there's evidence to support both possibilities. Karl "Chip" Case, an economist at Wellesley College who follows home-price trends, has studied the issue and found that high-end home prices held up very well in the Northeast during the early 1990s downturn. In that case, builders added too many low-end condominiums to the market, resulting in an oversupply that weakened prices for inexpensive properties. Also, many marginal neighborhoods that had begun to gentrify in the 1980s turned south when the region's economy faltered, sending prices of properties in those areas down.

But Mr. Case found the opposite in California in the early 1990s. There, a boom in immigration gave an unexpected boost to demand for lower-end homes, even though the overall market was extremely weak and prices for higher-end properties were falling.

So which will it be this time if the housing market slows dramatically? For now, it appears that the California scenario is the one most likely to play out. In fact, despite the recent low interest rates, real-estate agents report that sales of high-end homes have already slowed substantially over the past two years; in Atlanta, for example, there was recently a 22-month supply of homes priced $750,000 and above. By contrast, the supply of low-end homes remains tight around much of the country and prices for less-expensive properties continue to rise rapidly -- in part because of continued high demand from immigrant

families. Moreover, the latest economic slowdown appears to have hit wealthy households more than some other recessions. Think of all those dot-com millionaires who no longer have a job -- they're certainly not in the market for mansions anymore.

Michael Sklarz, chief valuation officer at Fidelity National Information Solutions, a Santa Barbara, Calif., research firm, says the high-end market (which he defines as houses with 5,000 or more square feet of space) peaked one to two years ago, and could slow further if there's a big hike in interest rates. Indeed, prices for high-end homes have been flat overall during the past year or two, he says, with sizable declines in some markets, like parts of New York City.

"It's just a thinner market, and when the market slows you have fewer players" to keep it going, he says. In his view, expensive homes are usually more volatile than other houses -- "they outperform on the upside and underperform on the downside."

The big question right now, in fact, is whether the recent weakness in the higher reaches of the market will seep down into the broader housing sector. Mr. Case, for one, worries that a big increase in interest rates could hurt all parts of the market, since it would discourage many families -- especially those that already locked in incredibly low interest rates during the past two years -- from buying and selling properties. If that happens, homeowners across the price spectrum could experience a decline in equity.

-- Mr. Barta is a staff reporter for The Wall Street Journal. His "House Talk" column appears every Friday exclusively on RealEstateJournal.com. Click here to e-mail him your questions about the residential real-estate market. Please include your first name and city and state. If your question is answered and posted, we will show your first name and city.

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