

Home Prices: A Case for Cautious Optimism

The July 2009 release of the Case-Shiller Composite-10 Index (CSXR) showed that home prices were up 1.36 percent from the previous month and 2.2 percent from their low in May 2009. According to the index, average U.S. home prices are comparable to their levels in the autumn of 2003—a decline of 33.5 percent from their peak in the second quarter of 2006. The recent gain was widespread—9 of the 10 cities in the CSXR reported increases, with Las Vegas the only exception. Nationwide, housing starts and building permits increased 1.5 percent to 598,000 and 2.8 percent to 580,000, respectively, to their highest level since November 2008.

The chart plots three monthly data series related to house prices and median household income between January 1990 and July 2009. Two of them are monthly home price indices: the CSXR and the house price index released by the Federal Housing Finance Agency (FHFA).¹ The third series is the House Affordability Index of Median Household Income published by the National Association of Realtors.² The base of all three indices is January 1991. During the early 1990s, home prices rose somewhat slower than mean household income. However, after 1997 home prices rose sharply to their peak in mid-2006 before dropping precipitously. Meanwhile, the affordability index grew at a much slower but more persistent rate. While the recent data suggest that home prices have stabilized, both home price indices remain well above the affordability index of median household income.

Many analysts are cautiously optimistic that the house price decline has ended, citing that house prices increased in June and July. There are several reasons for being cautious. First, the government is currently providing significant support to the mortgage market. On the demand side, the American Recovery and Reinvestment Act of 2009 authorizes a tax credit of up to \$8,000 for qualified first-time home buyers purchasing a principal residence between January 1, 2009, and November 30, 2009. With the tax credit due to expire by the end of November, it will be important to see if the demand for housing can be sustained after it expires. On the supply side, the Federal Reserve is purchasing up to \$1.25 trillion of agency mortgage-backed securities through a program that began in January 2009 and continues through the first quarter of 2010. The aim is to “reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally.”³ In light of this, it remains unclear how the housing market will perform in the absence of these government measures.

Meanwhile, the number of mortgage delinquencies and foreclosures in process rose during the second quarter of

2009. In a study that includes 64 percent of all outstanding U.S. mortgages, the Office of the Comptroller of the Currency and the Office of Thrift Supervision report that serious delinquencies (at least 60 days delinquent) increased by 11.5 percent from the previous quarter.⁴ On the other hand, home retention actions (including loan modifications and payment plans) initiated under the “Making Home Affordable” program rose 21.7 percent over the first quarter. This in turn kept the number of newly initiated foreclosures stable despite rising delinquencies. However, another cause for concern is the number of rising delinquencies on particular mortgage products such as Alt-A loans (particularly those with 5-year teaser rates) and payment-option adjustable-rate mortgages. The concern here is that these products might bring about a second wave of foreclosures, thereby leading to a further decline in home prices.

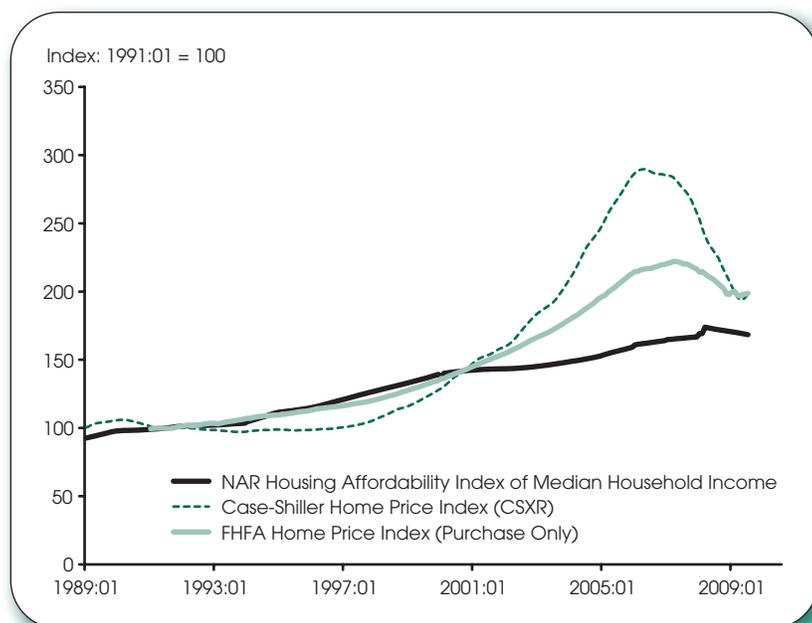
—Rajdeep Sengupta and Yu Man Tam

¹ For a discussion of how the two indices compare with each other, see Aubuchon, Craig P. and Wheelock, David C. “How Much Have U.S. House Prices Fallen?” Federal Reserve Bank of St. Louis *National Economic Trends*, August 2008; <http://research.stlouisfed.org/publications/net/20080801/cover.pdf>.

² See <http://www.realtor.org/research/research/hameth> for details.

³ Board of Governors of the Federal Reserve System. Press release, November 28, 2008; www.federalreserve.gov/newsevents/press/monetary/20081125b.htm.

⁴ The *OCC and OTS Mortgage Metrics Report* covers all types of first-lien mortgages serviced by most large mortgage providers (see www.occ.treas.gov/ftp/release/2009-118a.pdf).



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