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"Straight talk about the housing market"

By William Spiegel and Scott Schaen

NEW YORK (MarketWatch) — Economists, policy makers and consumers continue to seize upon any sign that the housing market is rebounding.

A common refrain from pundits is that a recovery may be seen in the next "one to two years." Unfortunately, based on the data, the truth is that a housing market recovery is still much further away than most are admitting, and there are no practical short-term solutions that will solve the problem. See "U.S. home prices at postcrisis lows: Case-Shiller."

It is understandable why so much attention is focused on the housing market. After all, as the housing market goes, so goes the economy. A home represents the single largest asset of most consumers, and the continued decline in home prices creates a negative wealth effect that hampers a full economic recovery. Moreover, construction and other housing-related industries are experiencing significant employment drops and these jobs will remain lost until residential construction rebounds.

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The steady drop in home prices generated a great deal of favorable headlines—and fueled a false assumption that once homes reached a point of affordability, new home buyers would be virtually tripping over each other in a race to buy. With the market remaining largely stagnant, many are citing a lack of access to credit, the high unemployment rate and a chaotic foreclosure process as the most critical barriers to reviving the real estate market. But these factors aren't the biggest obstacles, and it is misleading to suggest that governmental policies or the banking industry can expedite a real estate revival. Check out the chart: "Green shoots or false dawn for housing."

The reality is that reviewing foreclosure trends, evaluating lending practices and tracking housing starts doesn't provide any true insight into predicting when the market will regain its footing. Instead, we should be focused on the two pieces of data that really matter: excess housing stock and household formation. The excess housing stock needs to be absorbed by household formation before the housing market returns to equilibrium. Once the market returns to equilibrium, housing prices will stabilize and eventually increase, followed by a rebound in residential construction necessary to meet the new demand for houses. Unfortunately, it doesn't appear that this is achievable in the short term.

Today, we estimate there are approximately 3.5 million excess homes in the country, which serve as an inhibitor to achieving a healthy recovery. Many of these homes were built when housing prices were rising. When the bubble burst and prices dropped, demand for the units disappeared.

Why luxury home prices may fall further

Home prices hit their lowest levels since 2006, and experts say more losses could be on the way—in particular for the nation's priciest properties, AnnaMaria Andriotis reports on Lunch Break. Photo: AP.

Unfortunately, there is no easy solution to the problem of too many homes. We could literally bulldoze the excess inventory, but such an approach is simply a political impossibility as no one would be willing to bear the cost.

That leaves us with a metric that is even more difficult to affect: household formation. Household formation will eventually absorb the excess supply of houses.

Though household formation is the most underreported driver of the housing market, its importance cannot be overstated. Key factors that influence household formation—such as change in marital status, birthrates, immigration, the combination of households in order to share costs, and adult children living with their parents for longer periods—are difficult to actively influence. In one effort, Senators Charles Schumer and Mike Lee recently introduced a bipartisan bill that would intent foreign nationals to invest at least $500,000 in residential homes by granting them a three-year renewable visa. However, today’s political environment almost assuredly serves as an obstacle to the bill’s passage, and it would only be a drop in the bucket if it did.

The reality is that only in time and with patience will the excess supply of homes be absorbed by newly formed households, allowing the housing market to return to equilibrium.

How long will it take? As previously mentioned, there are approximately 3.5 million excess single-family homes, multifamily homes, and rental units in the country today. Assuming annual household formation of 1 million, simple math suggests that it will take at least three and a half years—significantly longer than most predictions—for the national market to finally regain a healthy footing. Importantly, this is before taking new home construction into account, which will slow the process of absorbing the current excess supply.

Of course, this is a simplified analysis. First, real estate is a local business. Some markets, such as Minneapolis and Fort Worth, will rebound much more quickly than Miami and Las Vegas. On the flip side, certain homes included in the 3.5 million excess housing units will never be inhabited and will be "deleted" from the housing supply. Additionally, household formations could be higher than or lower than historical levels. In the 2000s, household formation declined substantially as compared with the 1990s. Continued low formation levels will prolong the housing downturn. By and large, though, it will be some time before the market returns to pre-recessionary levels.

As the data shows, the market's recovery remains a work in progress. Unfortunately, there is no quick fix to our national housing market predicament, and it is important that economists, policy makers, investors, real estate professionals and home builders set their expectations accordingly. The time is long overdue for straight talk about the housing market, anything else is simply irrational exuberance.

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