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## **WILL THE HOUSING BOOM BECOME A BUST, PUSHING THE U.S. INTO RECESSION?**

Over the last few years U.S. home prices have soared. Nationally, prices rose at double-digit rates in both 2004 and 2005, something we haven't seen since the inflationary late-1970s. Furthermore, gains in certain regions of the country, notably the West and south Florida, have significantly outpaced the buoyant national averages.

### **WHY HAVE HOME PRICES RISEN SO SHARPLY?**

There are a number of reasons, including increased demand. Population continues to grow at about 1% annually, due partly to immigration. In addition, the numerous children of the Baby Boomers are setting up households. Rises in the average prices of new homes probably also reflect the taste for larger homes and the growth of the upscale home market.

The major driver, however, behind the sharp rises of recent years has been increased housing affordability, made possible by abnormally low interest rates that prevailed during 2002 and continued into early 2004. Those low rates allowed a larger segment of the population to purchase a first home or to move to a more expensive home. That trend of increased home ownership was reinforced by the increased availability and promotion of novel mortgage products, such as interest-only and negative-amortization mortgages, which allowed lower payments compared to more conventional loans.

Indeed, after the Fed started raising rates in mid-2004, such products were increasingly used to mitigate the damage of those rate increases on housing affordability. "Exotic" mortgages have helped to extend the period of rapid home price appreciation and, in some cases, have even fueled speculative housing activity.

Ironically, the result of the increased access to housing had been to lift prices so high that now housing affordability, by some measures, stands at its lowest level in 15 years. This is due, not only to the sharp rise in short-term interest rates over the past couple of years, but also to home prices that have far outpaced income growth. As home prices skyrocket, large numbers of potential home buyers simply get priced out of the market, not being able to borrow enough to purchase the higher-priced homes.

This decreased affordability means that the housing market will be less vibrant going forward compared to the last couple of years. Already, we have seen home sales and housing starts decline from their recent peaks. There was a 10.5% drop in new home sales in February (the drop was 29.4% in the West).

This means that housing's strong contribution to overall economic growth over the past few years is now gone. Housing is now poised to detract from growth as home prices are stalling or even declining. Home-price appreciation likely has contributed heavily to the strong consumption growth that has buoyed the economy. As we saw during the equity market bubble of the late-1990s, people tend to consume more when they feel wealthier. In this case, it's the price of their homes—rather than the performance of their portfolios—that's producing “the wealth effect.”

This perceived housing wealth has also fueled greater household borrowing (for example, more home equity loans and more cash-out during refinancing) that has been used to purchase such things as home improvements, household durables like autos and furniture, and other consumer goods and services.

### **IF HOUSING IS IN DECLINE, IS ECONOMIC GROWTH HEADED FOR A COLLAPSE OR EVEN RECESSION?**

Only if home prices were to collapse would the economy stumble badly perhaps even falling into recession. In such a scenario, there would be serious repercussions, not only for the real economy but also for the financial system. Much of the debt run up of late has been household debt in the form of housing-related debt, including both mortgages and home-equity loans. If the housing market became extremely distressed, with prices falling sharply, banks, mortgage lenders, and mortgage insurers might experience large losses that could lead to further economic distress.

In those circumstances, the government would likely take aggressive actions to mitigate the fallout from such a housing market meltdown, similar to what occurred following the bursting of the equity market in early 2000.

But, without a significant home-price decline nationally, it is hard to see anything more than a moderate hit to the trajectory of economic growth. Since we don't envision a significant decline in the national average of home prices, although prices could decline sharply in those areas, such as Florida and California, where home prices soared over the past few years, we will probably find a soft-landing— a stabilization of average national home prices. This would be similar to what we saw in Australia and the UK following their “housing bubbles”. Nonetheless, even a stabilization of home prices (that is, little further rise) means that economic growth in the near-term is likely to be more subdued than we have been accustomed to recently.

Editor's Note: This newsletter is part of a regular series of comments on various aspects of the economy and the financial markets from Leo Kamp, Managing Director and Chief Investment Economist, TIAA-CREF Investment Management, LLC, part of TIAA-CREF, a national financial services group of companies and the leading provider of retirement services in the academic, research, medical and cultural fields. With more than \$370 billion in combined assets under management (12/31/05), TIAA-CREF ranks as one of FORTUNE magazine's list of largest companies (April 2005).

Leo also is available to comment on economic data. If you wish to speak with him or to be removed from future distributions, please notify Katherine Miller at 202.637.8949.