Residential Real Estate, Demographics, and the Economy

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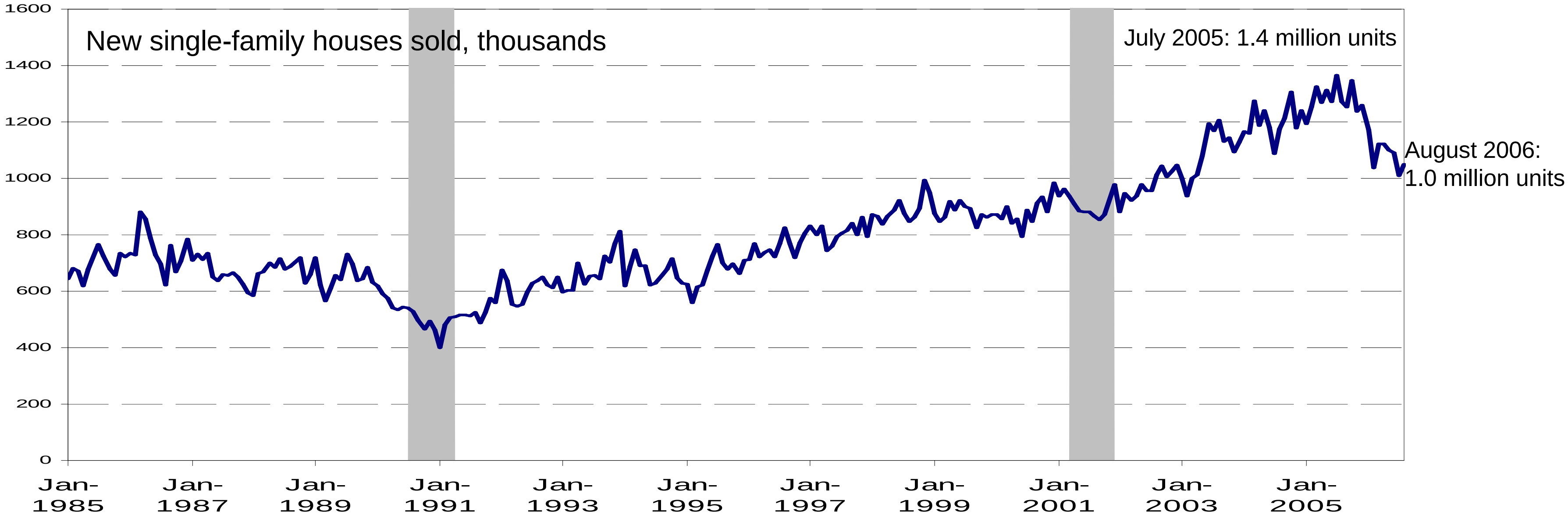
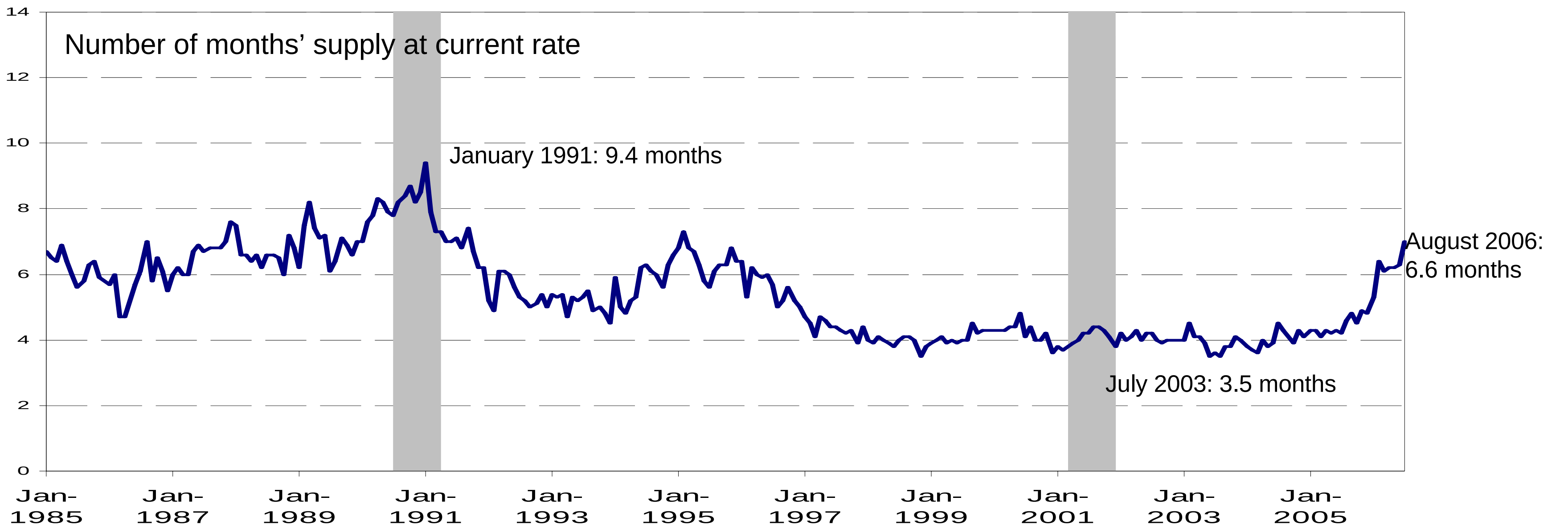
Overview

- Housing markets have weakened across the nation.
- It is not clear how a “correction” will play out, though a major decline in prices is unlikely.
- New England’s current housing cycle looks similar to national.
- New England population trends pose longer-term risks for housing market.

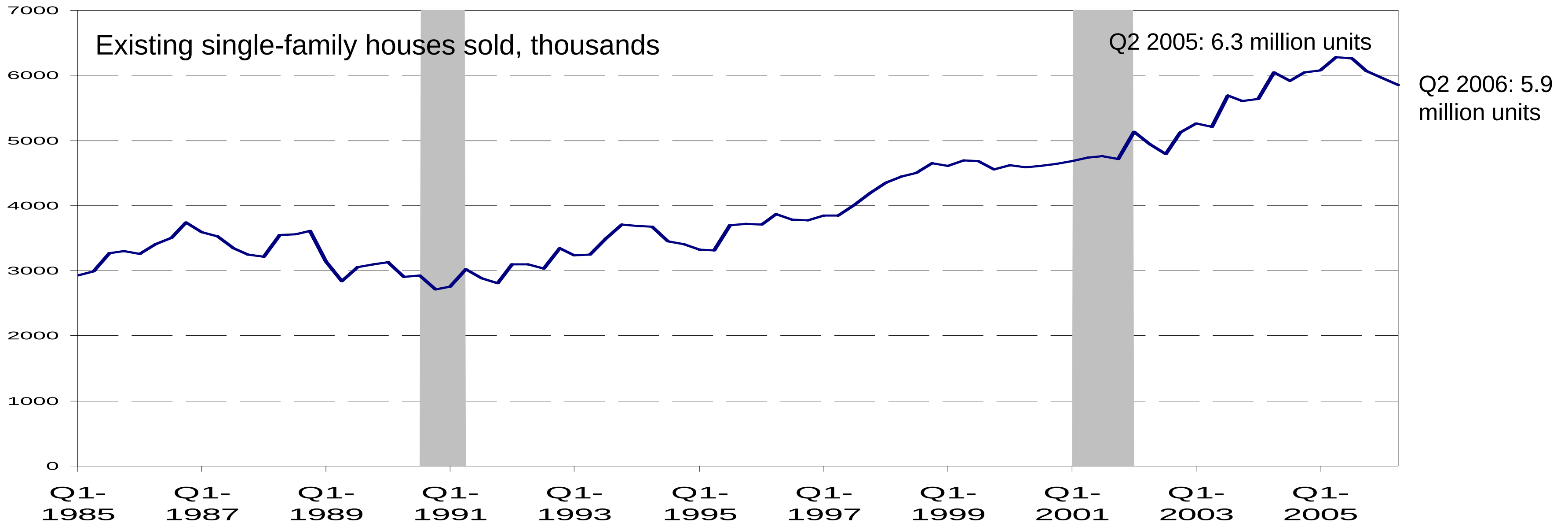
Nationwide new home sales are down… inventories of unsold homes are rising.

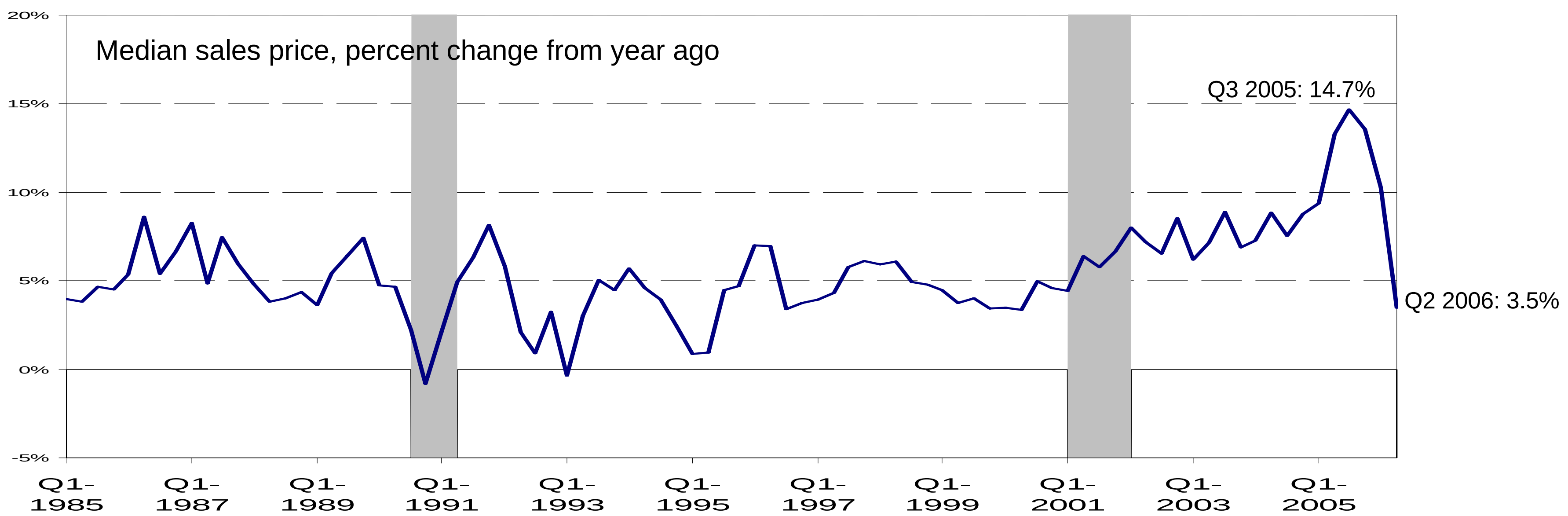




Source: Bureau of the Census.

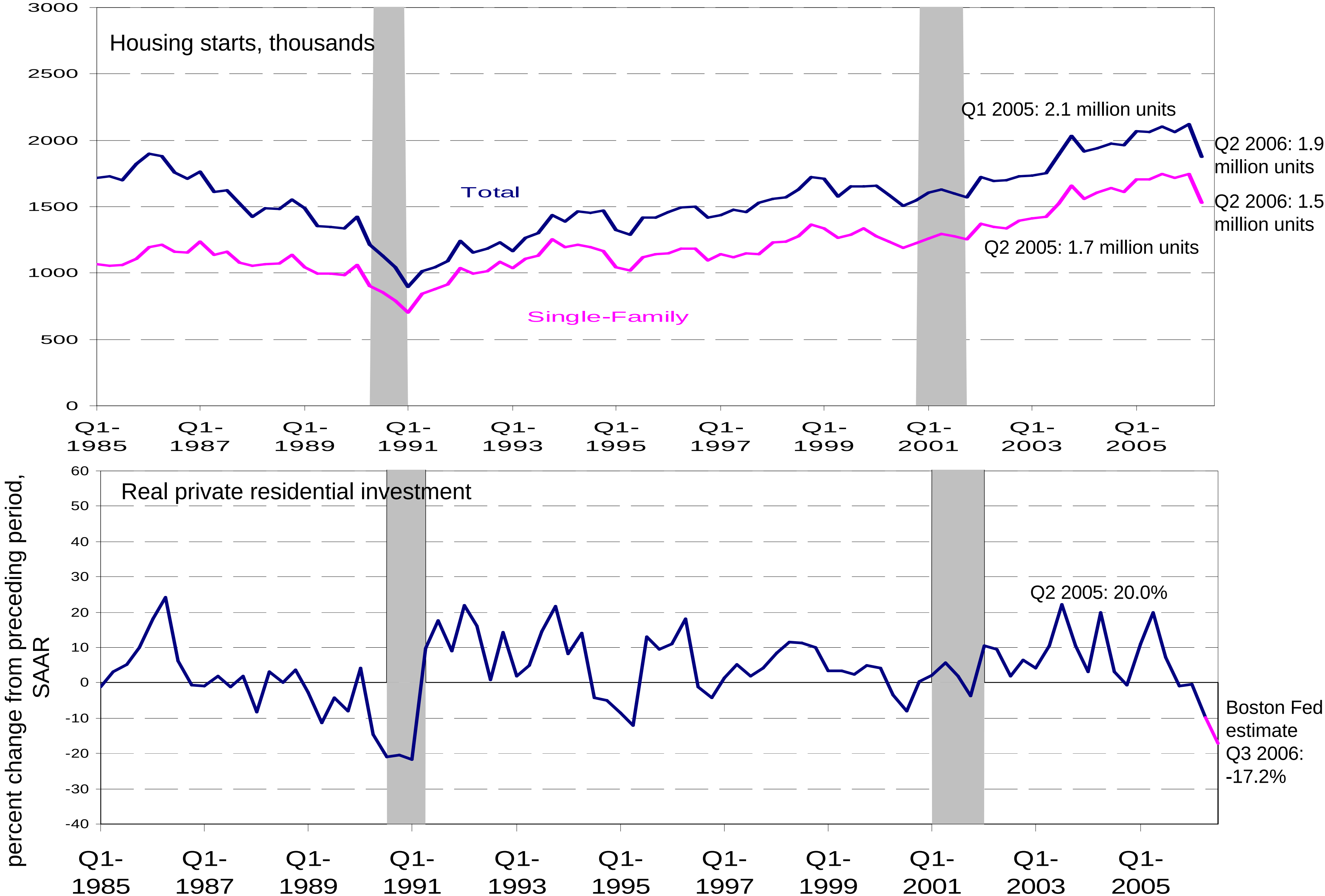
Sales of existing homes have fallen … median selling prices have stopped escalating.





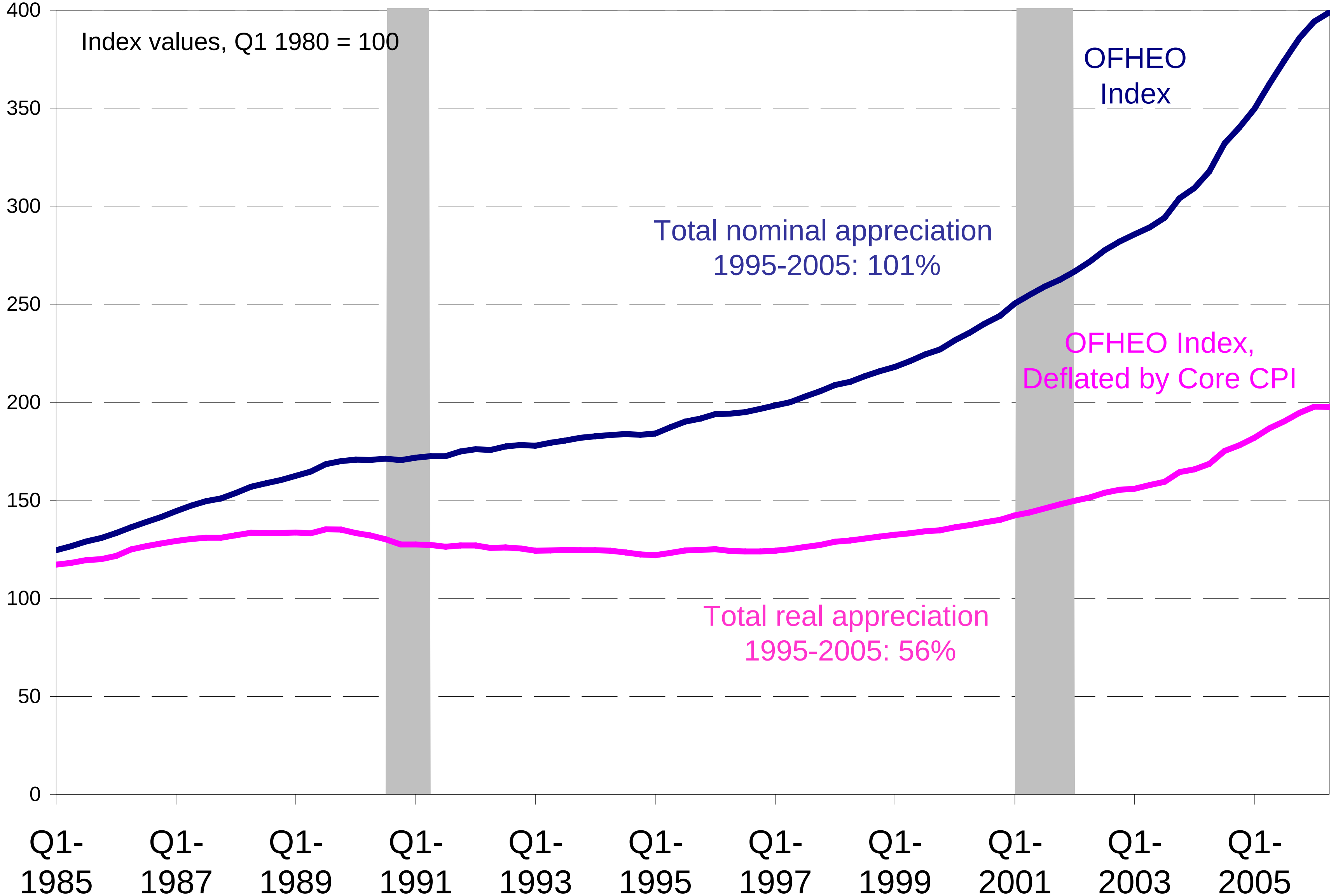
Source: National Association of Realtors.

Home builders are curtailing construction … overall housing investments are slowing.



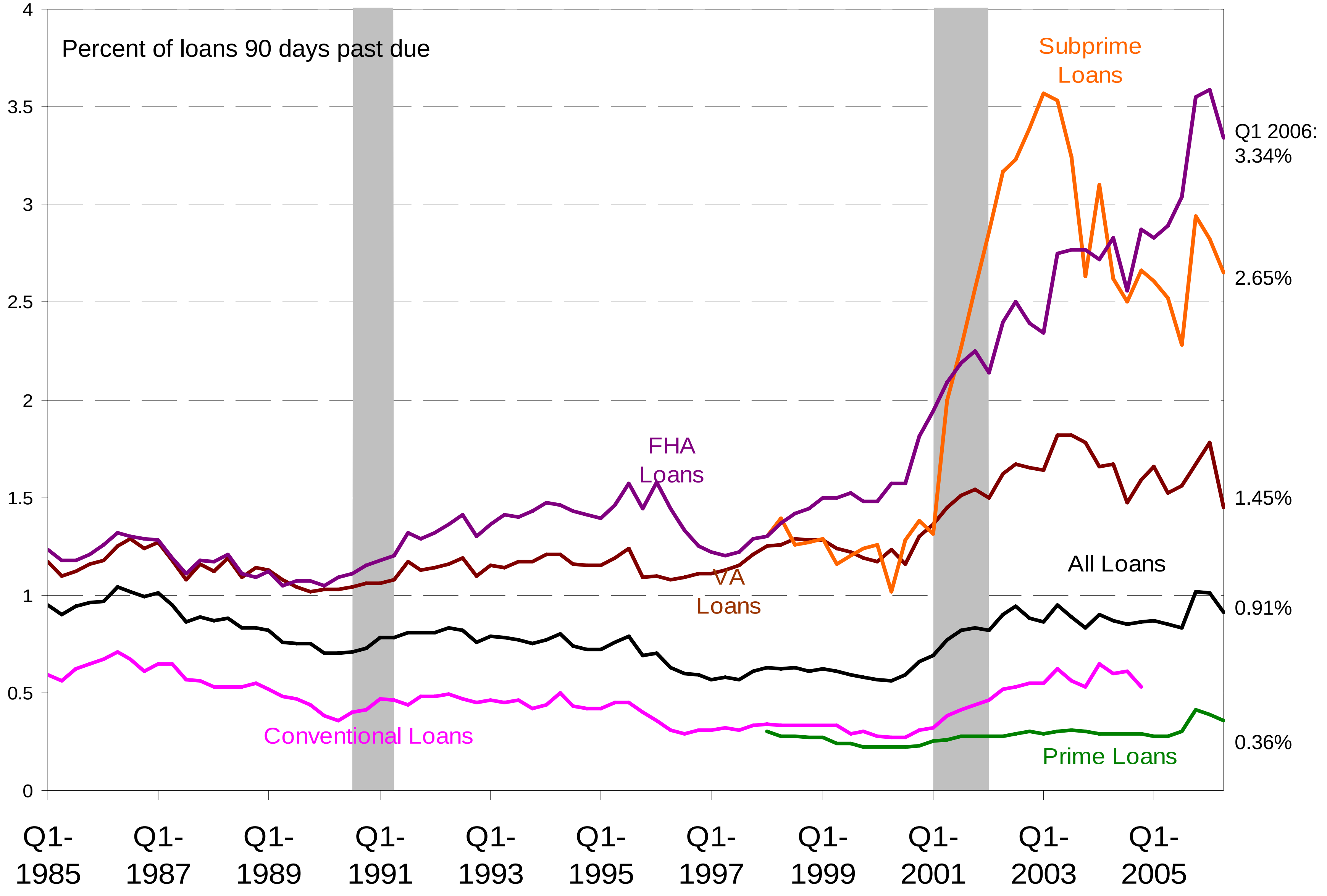
Source: National Association of Realtors.

Housing wealth has stopped increasing.



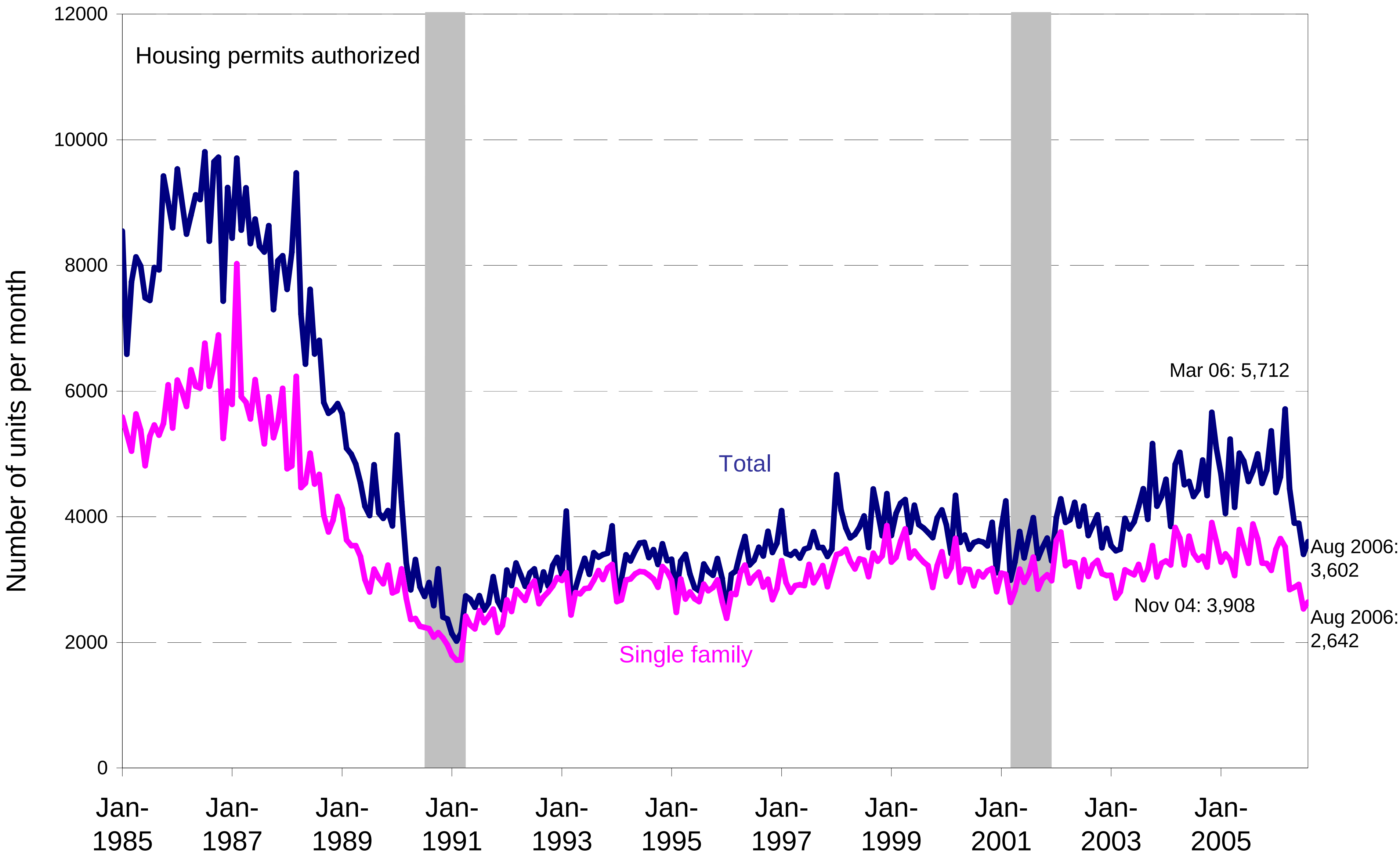
Source: Office of Federal Housing Enterprise Oversight.

Mortgage delinquencies are high in the subprime category.



Source: Mortgage Bankers Association.

Housing construction is slowing in New England.



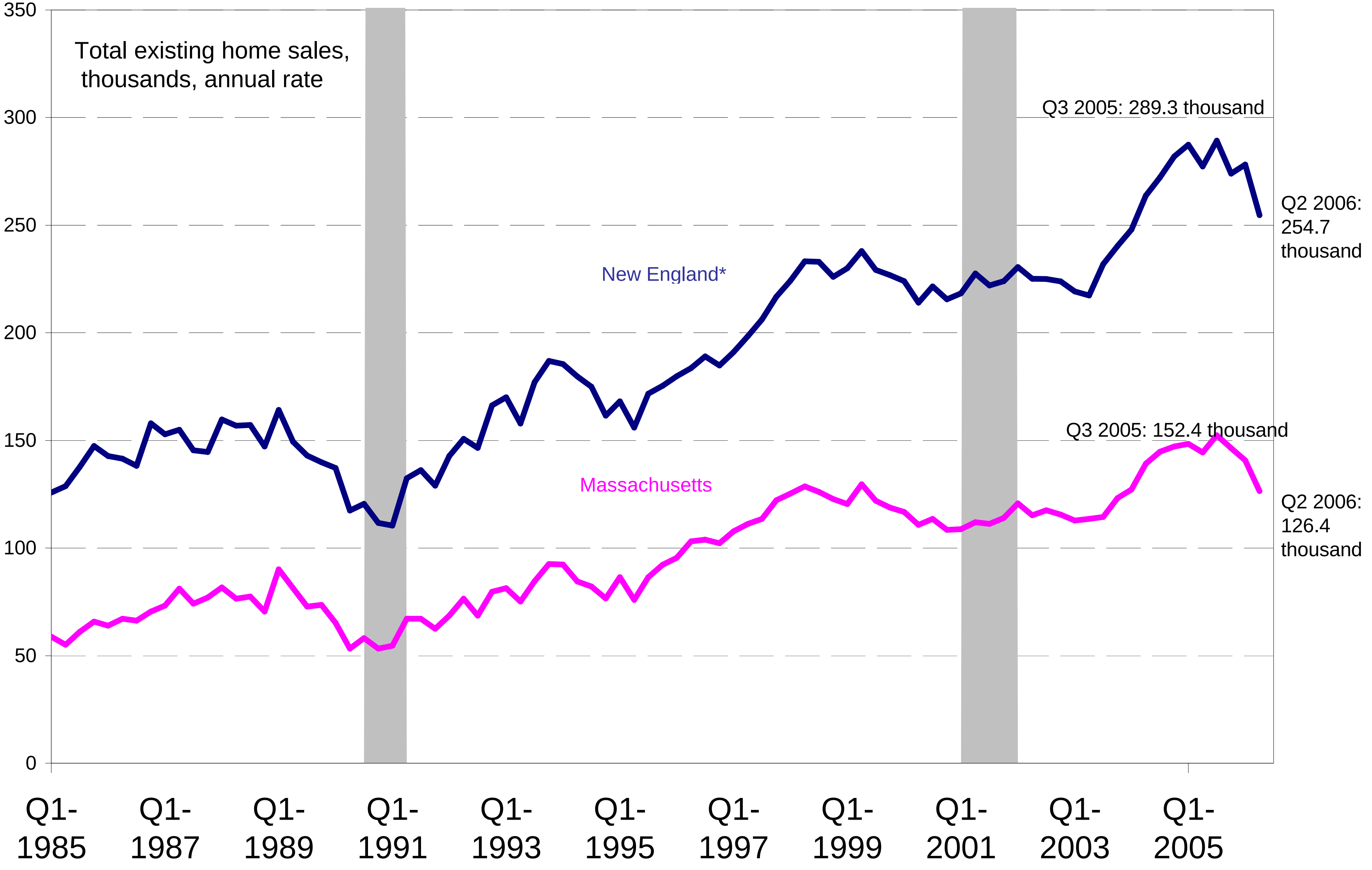
Source: Bureau of the Census.

The number of single-family permits authorized is down in all New England states

	January 2005 - August 2005	January 2006 - August 2006	Percent Change, 2005 - 2006
Connecticut	5,827	4,906	-16%
Maine	5,359	4,687	-13%
Massachusetts	9,320	7,963	-15%
New Hampshire	4,305	3,596	-16%
Rhode Island	1,216	1,062	-13%
Vermont	1,878	1,821	-3%
New England Total	27,905	24,035	-12%
United States	1.2 million	1.0 million	-12%

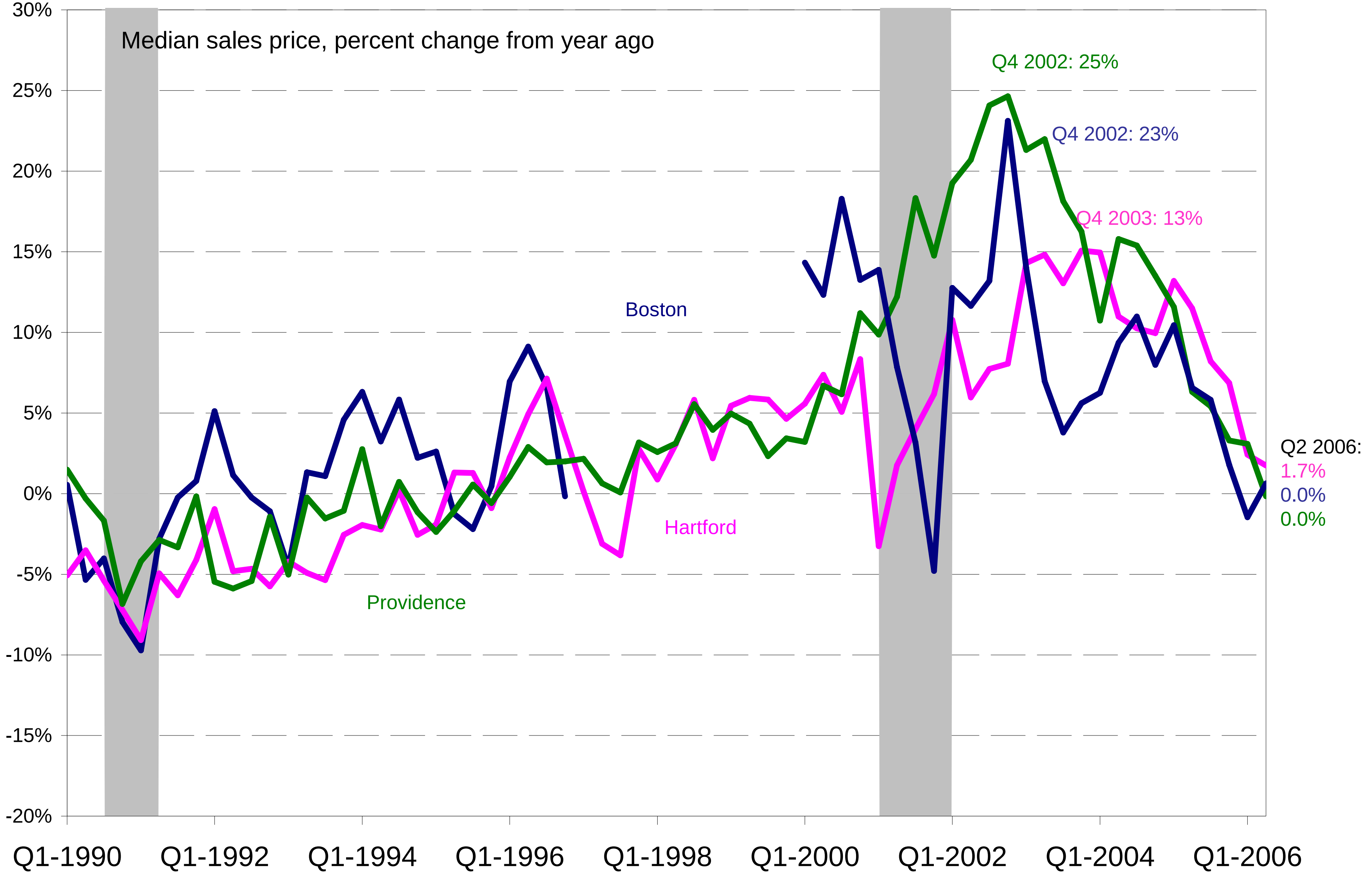
Source: Bureau of the Census.

Existing home sales are falling in New England, especially in MA and RI.



*New England total excludes New Hampshire and Vermont, as data for these states is not available in all periods.
Source: National Association of Realtors

Median selling prices are similar to last year's levels.



Source: National Association of Realtors

OFHEO estimates that house prices are now falling in Massachusetts, Maine, and the industrial Midwest.

Percent change in OFHEO index,
Q1 2006 – Q2 2006

States with largest gains		States with largest declines	
Washington	+15.5%	Michigan	-2.8%
Utah	+15.9%	Massachusetts	-1.7%
Idaho	+16.0%	Maine	-0.8%
Oregon	+17.0%	Ohio	-0.2%
New Mexico	+18.0%	Indiana	-0.2%

Source: Office of Federal Housing Enterprise Oversight.

Some New England states have a large and growing share of subprime loans.

Subprime loan share of mortgage originations

	2003	2004	Change
Connecticut	10.2%	17.2%	+7.0%
Maine	10.6%	10.7%	+0.1%
Massachusetts	8.0%	15.8%	+7.8%
New Hampshire	9.6%	12.6%	+3.0%
Rhode Island	14.0%	25.3%	+11.3%
Vermont	4.5%	8.0%	+3.5%
United States	9.9%	14.8%	+4.9%

Source: Mortgage Bankers Association.

Why is the national housing market correcting?

Two views:

#1 Prices got too high relative to incomes.
Housing bubbles have to burst.

#2 Prices rose because interest rates got so low.
Now interest rates have risen.

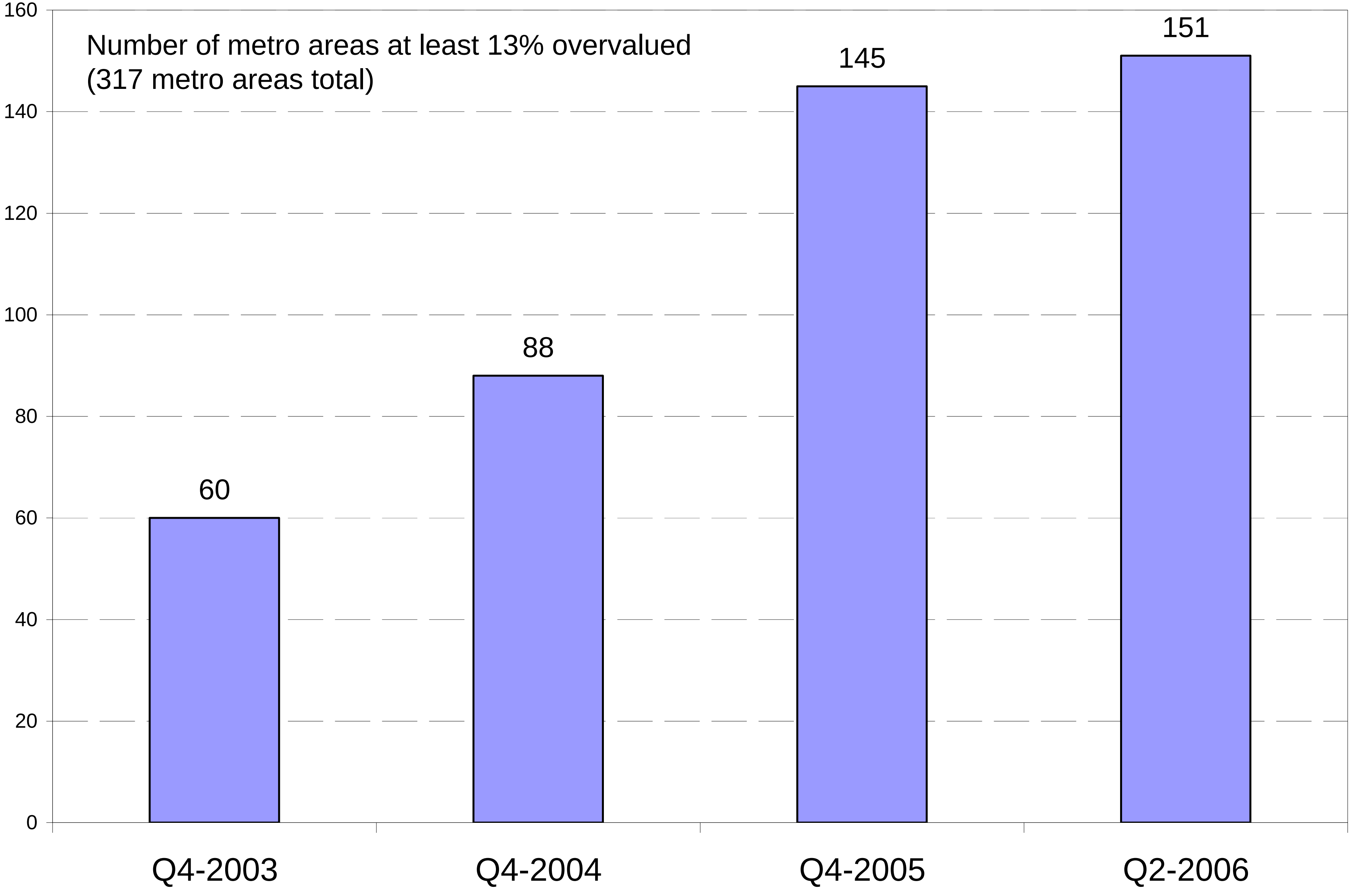
#1 The housing bubble story

- Assumes that economic fundamentals explain house-price-to-income ratios over long stretches of time.
- Fundamentals include mortgage rates, incomes and employment, building costs & constraints, amenities.
- Average house-price-to-income ratios can differ across cities.
- For any given city, big gap between actual house prices and fundamentals-based prices indicates overvaluation.
- Sustained overvaluation $\longrightarrow$ housing bubble.

#1 The housing bubble story (continued)

- Timing of the bubble bursting is unpredictable.
- Decrease in housing sales volume is a leading indicator.
- Eventually, sellers adjust their price expectations downward to match what buyers are willing to pay.
- House prices stagnate or fall.

About one-half of all metro areas are overvalued, according to National City.



Source: National City Corporation.

California and Florida have many severely overvalued markets, according to National City.

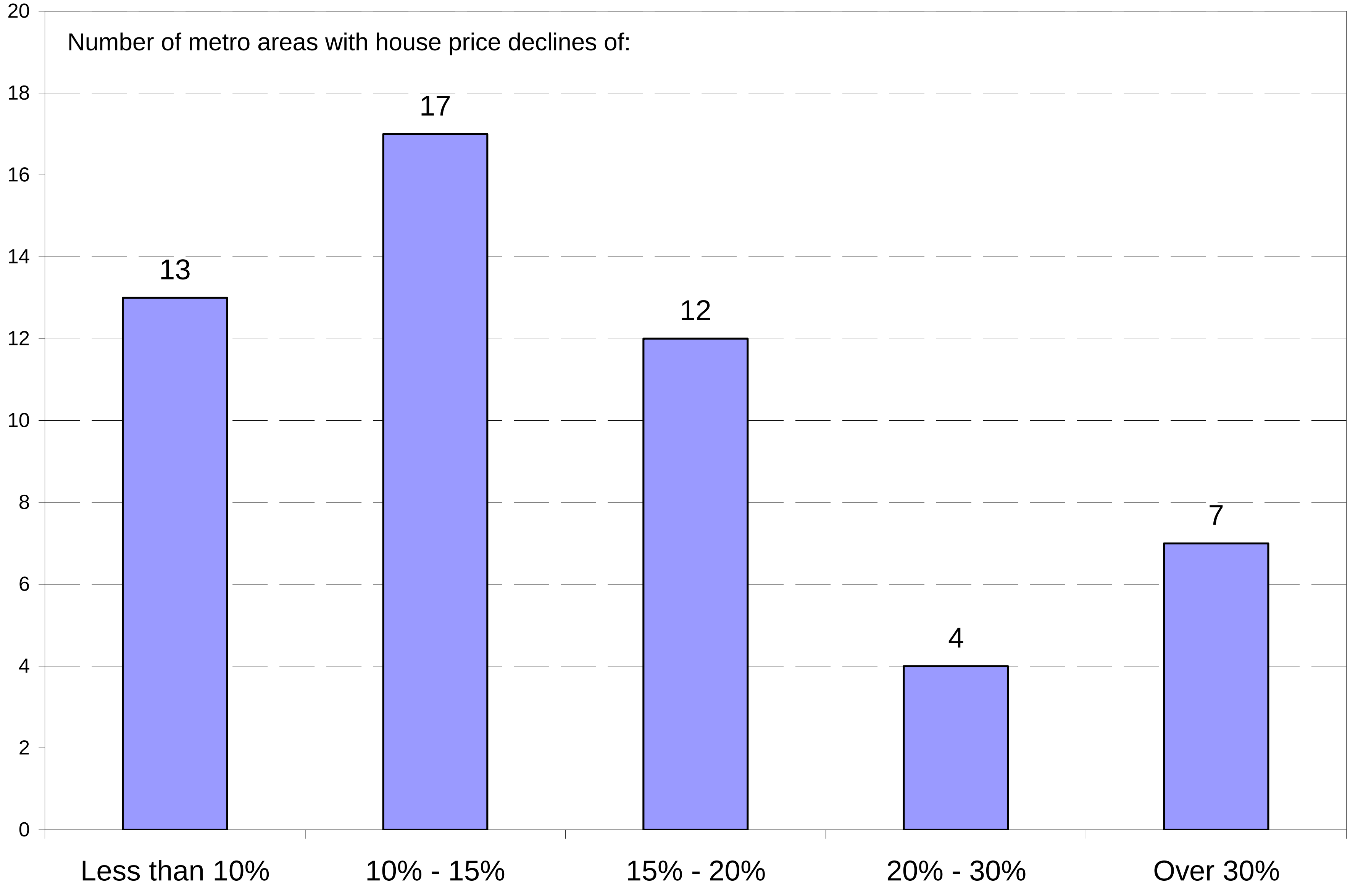
- Of the 60 metropolitan areas with overvaluation >= 40 percent:
  - 26 are in California
  - 14 are in Florida
  - 20 are in other parts of the U.S. (including 5 in the Northeast)
  - 0 are in New England

- Overvaluation among New England metropolitan areas is mixed:

Barnstable, MA	34.7%	Springfield, MA	18.2%
Providence, RI	29.5%	New Haven, CT	14.6%
Worcester, MA	27.0%	Boston, MA	5.7%
Manchester, NH	21.5%	Hartford, CT	5.5%

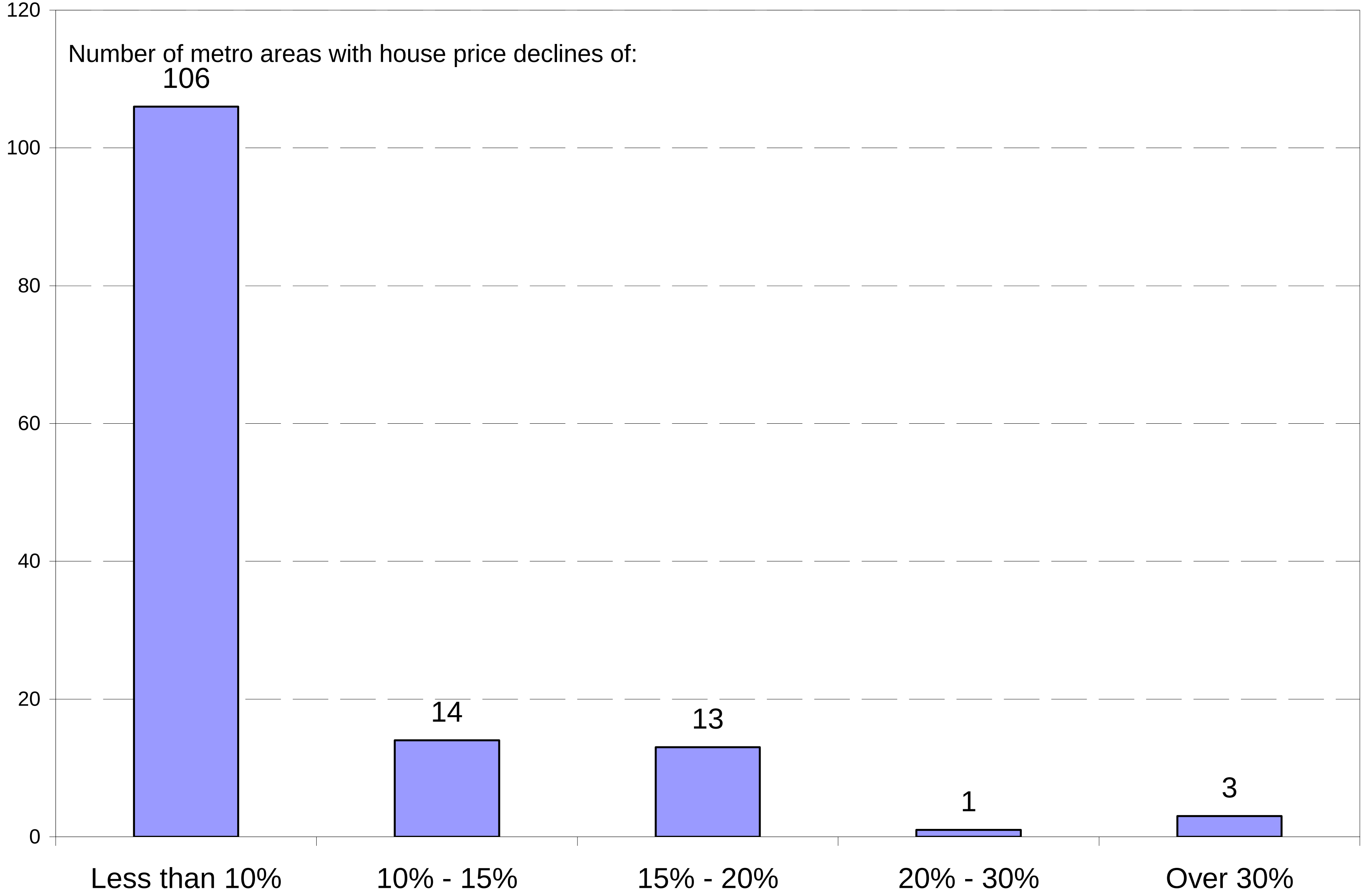
Source: National City Corporation.

51 metro areas were overvalued by more than 30% at some time during 1985 – 1995. Almost ALL experienced a significant price decline.



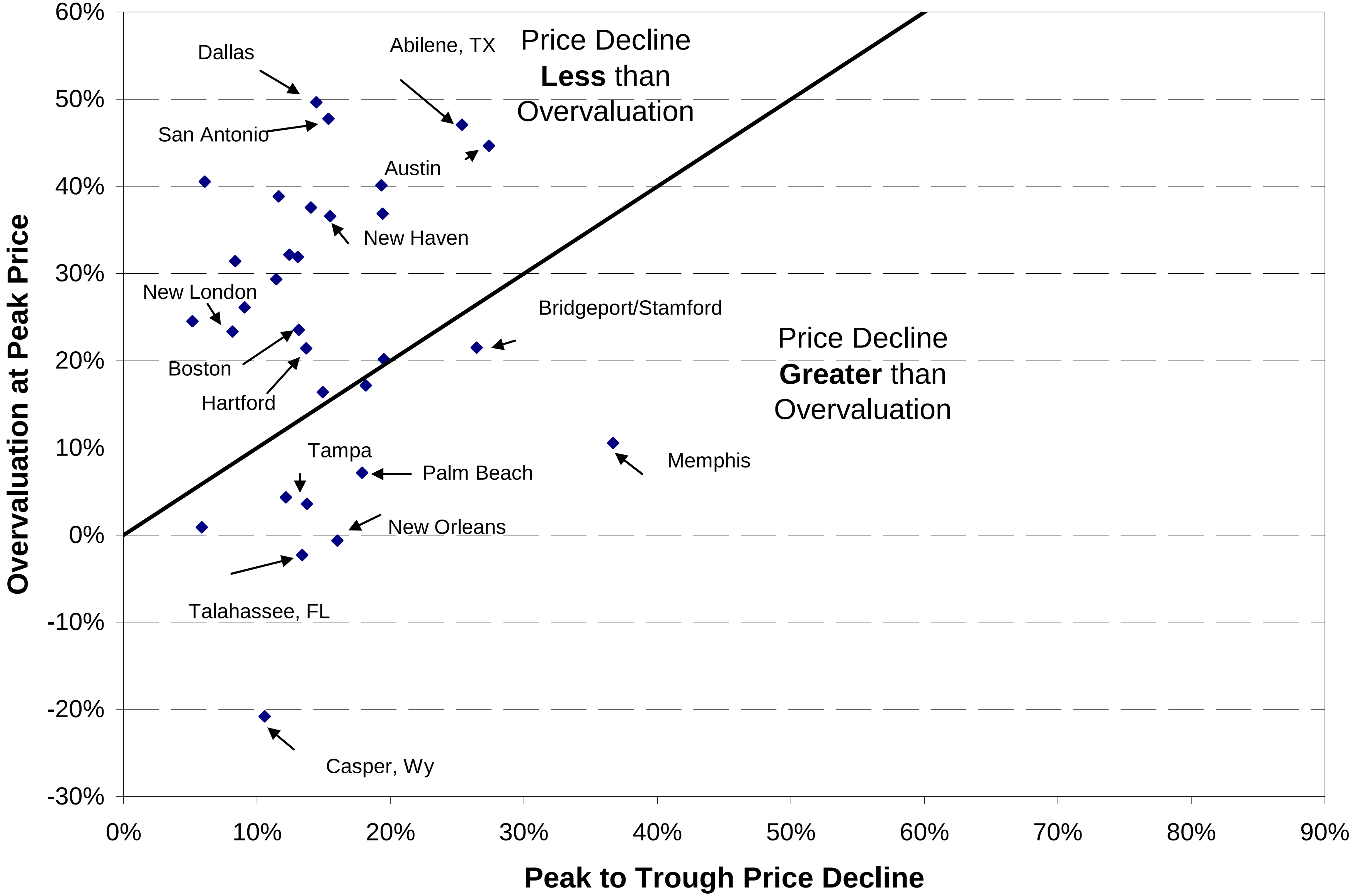
Source: National City Corporation.

134 metro areas were overvalued by between 13% and 30% at some time during 1985–1995. 106 experienced NO significant price decline.



Source: National City Corporation.

House prices usually fell by LESS than estimated overvaluation in the 1980s.



Source: National City Corporation, OFHEO.

#2 The interest rate story

- Backs out equilibrium price of owner-occupied housing, based on likely returns.
- Key determinants include interest rates, rents for comparable units, tax laws, reasonable estimates of capital gains.
- House prices can differ across cities.

(continued)

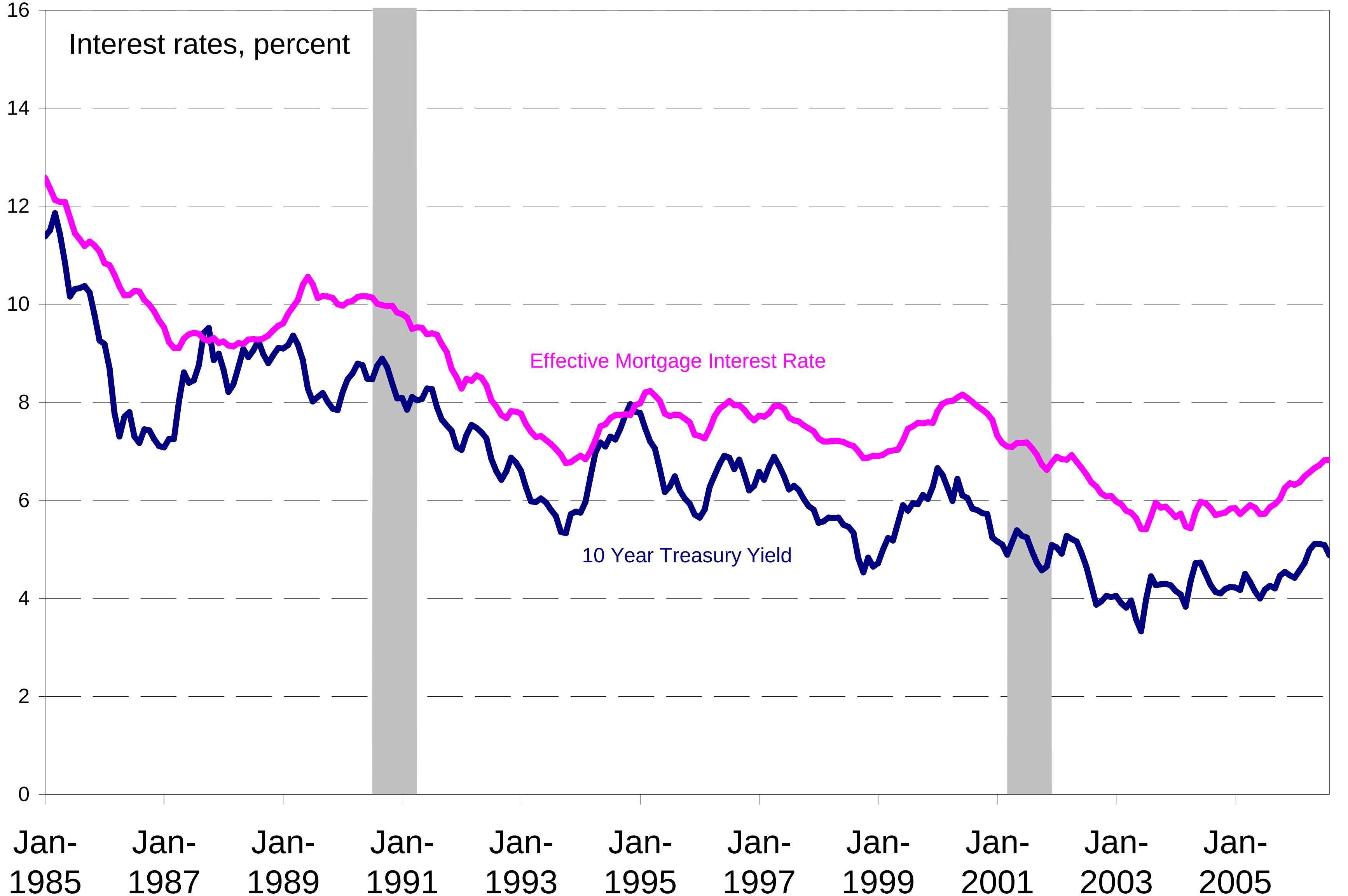
#2 The interest rate story (continued)

- For any given city, big gap between actual and equilibrium prices indicates one of two things:
  - People using flawed information

OR

  - People’s decisions based on factors that economic models don’t include
- Eventually, house prices return to equilibrium.

Interest rates got very low in the early 2000s and lenders offered new mortgage products



Source: Federal Reserve Board, Federal Home Finance Board.

Careful study by Himmelberg-Mayer-Sinai concluded that house prices in most markets are not much higher than equilibrium levels.

- In Q4 2003, only 4 metro areas (out of 47 total) had an “imputed rent” on owner-occupied housing greater than prevailing market rents.
- By Q4 2005, 26 metro areas were overvalued by this measure.
- However, very few markets were severely overvalued.

Overvaluation in Q4 2005	Number of metros
Less than 10%	11
10% - 15%	4
15% - 20%	5
Over 20%	6

Increase in interest rates puts downward pressure on prices.

- But, as in the housing bubble story:

  Timing is unpredictable

  Decrease in home sales is a leading indicator

  Eventually, sellers adjust their prices to match what buyers are willing to pay

  House prices stagnate or fall

- So our housing market data don’t tell us which model is correct!

House price declines are correlated with recessions.

1980s case study of 41 state house price booms:

15 states had a recession

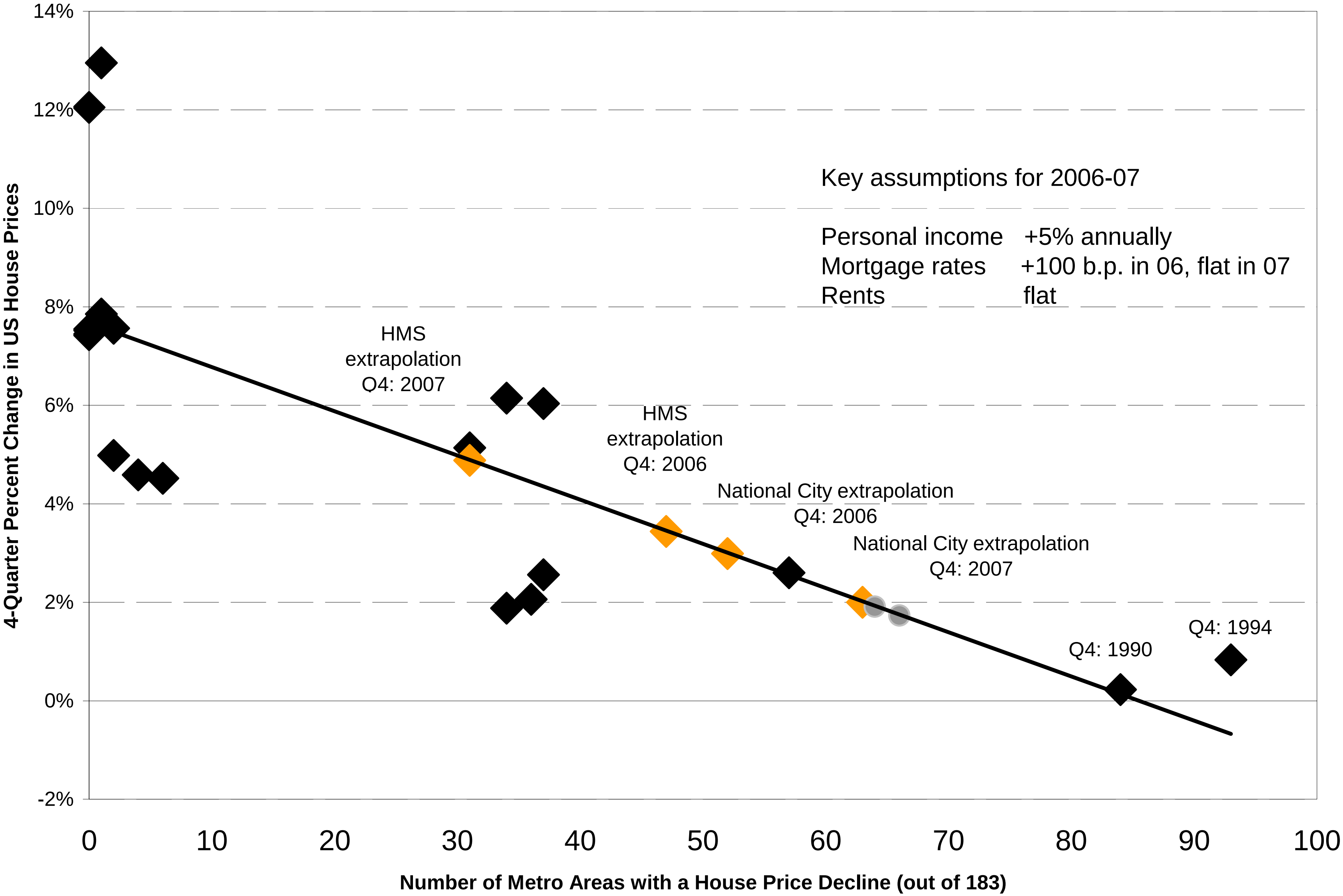
In 13, house prices fell.

26 states had no recession

House prices fell in only 7.

Source: Kodrzycki and Gerew "Using State and Metropolitan Area House Price Cycles To Interpret the U.S. Housing Market ," forthcoming.

Combining and extrapolating:
National home prices likely to be flat in 2006, rise modestly in 2007

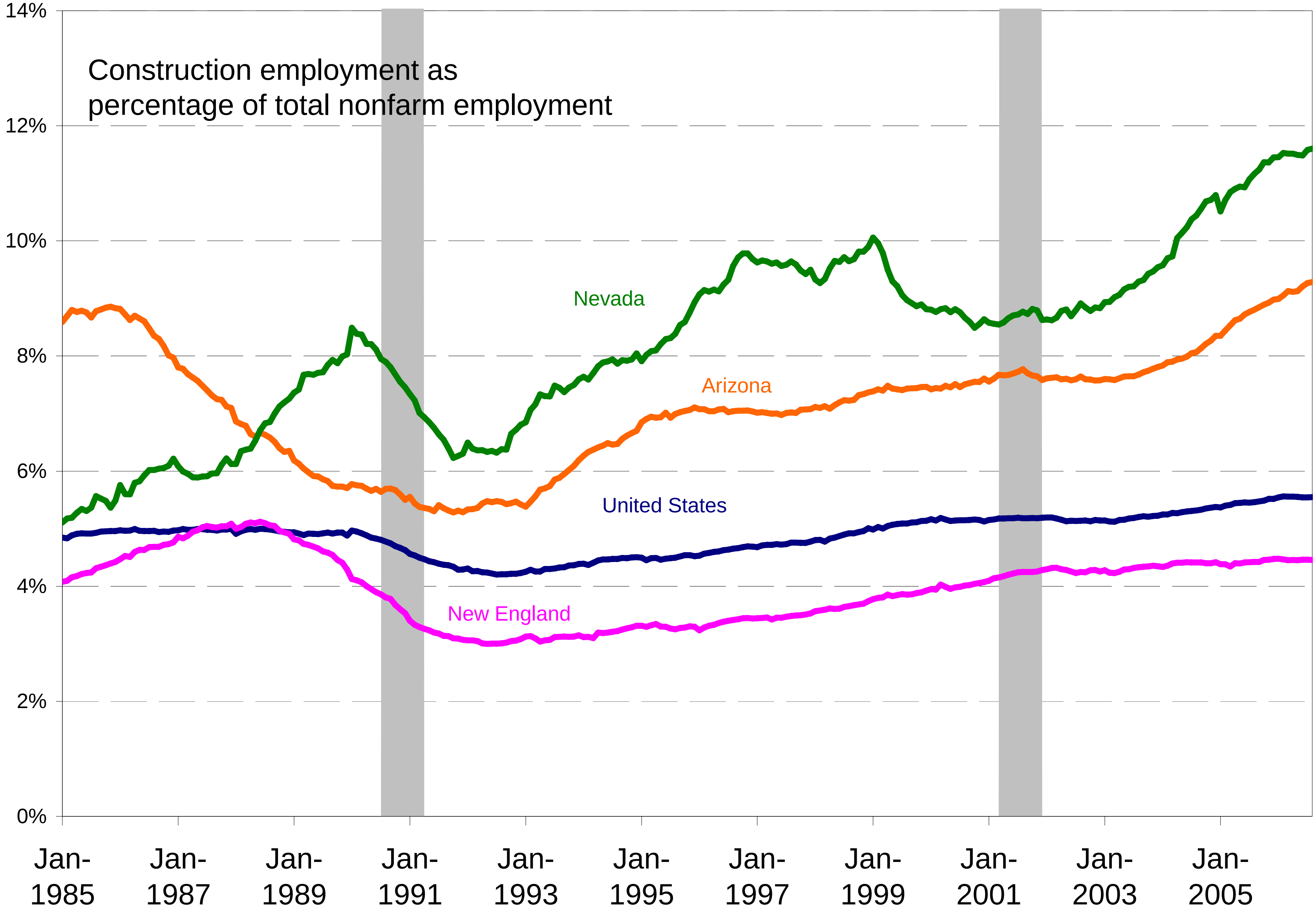


Source: Kodrzycki and Gerew "Using State and Metropolitan Area House Price Cycles To Interpret the U.S. Housing Market ," forthcoming.

How about New England housing markets?

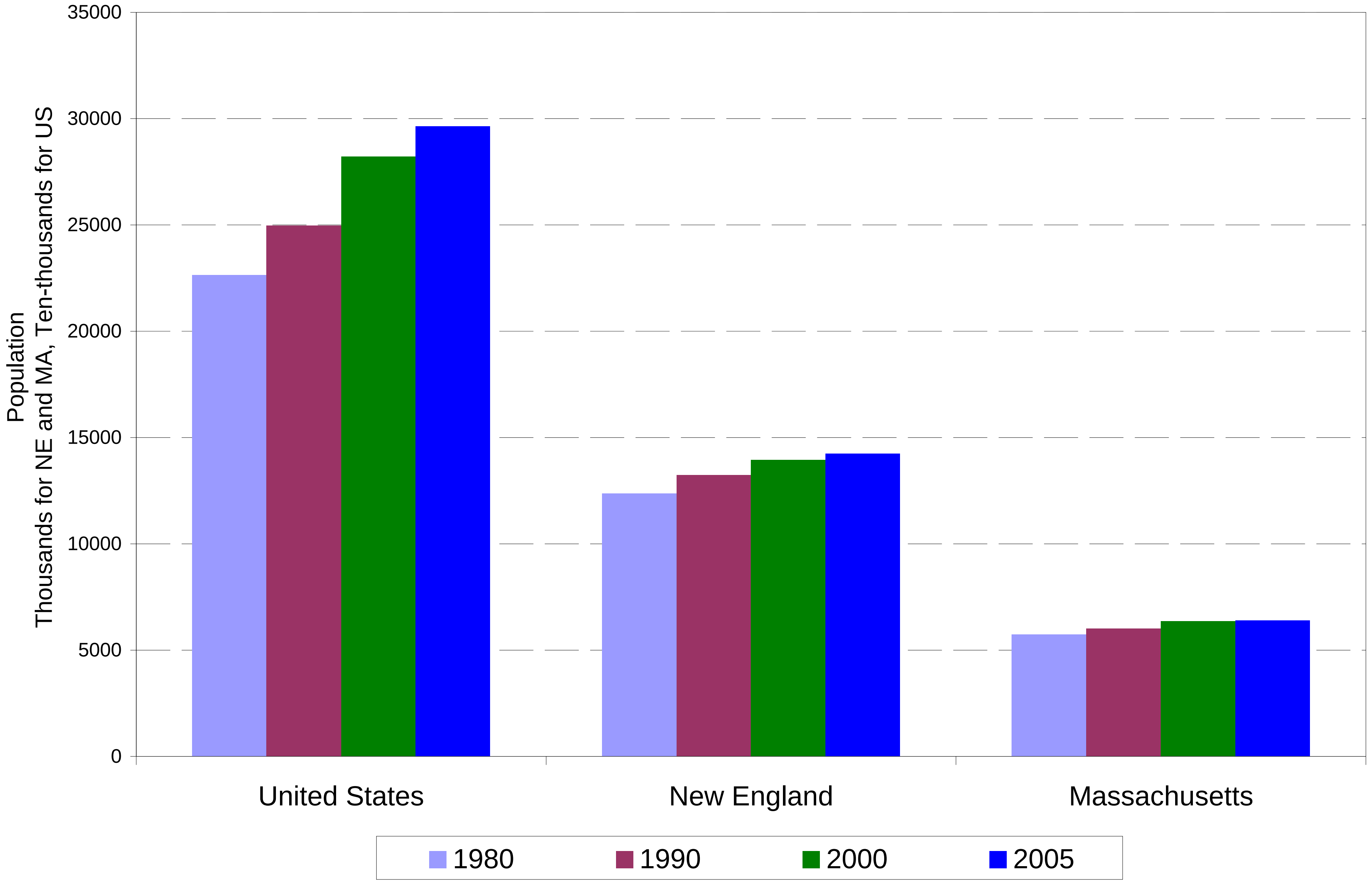
- Overvaluation measures not out of line here, as they were in the 1980s.
- Interest rate movements same as national.
- Economy and demographics different from national– both plusses and minuses.

Fortunately, construction is not a major driver of the New England economy



Source: Bureau of Labor Statistics.

Slow regional population growth limits demand for housing.



Source: Bureau of the Census.

High presence of baby-boomers poses risks over the coming decade.

Share of population ages 45 to 64 years old:	
United States:	25.0%
New England:	27.0%

- Move to smaller living quarters and retirement locations– spread out over time?
- More patient sellers– less panic selling?
- Risk: Will young adults want to locate here?

Conclusions

- A housing correction is happening nationwide, damping economic growth.
- House prices are inherently hard to predict.
- A best guess is flattening prices, although some markets will likely see a drop. New England is not especially “out of line.”
- New England’s differences from the nation:
  - Construction is not a big driver of the regional economy.
  - Slow population growth limits demand and poses some risks ahead.
- Keep your eyes on the rest of the economy!