

Underneath Housing Prices - Bubble Or Solid Foundation?

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*A brief review of the impact of interest rates and immigration
on real estate prices and industry employment.*

Last week, a friend told me that her friend's acupuncturist's astrologer predicted a decline in housing prices for summer of 2003. While I was trained as an economist, so you might think I feel threatened when palm readers make real estate forecasts. But, I am a humble economist and I believe in the free market. I have always felt that regulating fortunetellers but NOT economists was unfair. It is the quality of the results, not the rigor of the analysis that matters. Besides, I am sure that astrologers charge less than economists (and real estate agents). Another reason to let them practice in peace.

However, if you want more than that astrologers' view, I offer the following simple explanation of why I do not anticipate a fall in housing prices. **It has to do with sex in foreign countries. If people keep having babies abroad (safe prediction) and they see America as the promised land, so long as our immigration flood gates remain open, then demographics, the fundamental driver behind US housing growth guarantee that prices will not fall.** But let me distinguish my forecast from the astrologer with some rigor.

Focus on the Resale Market

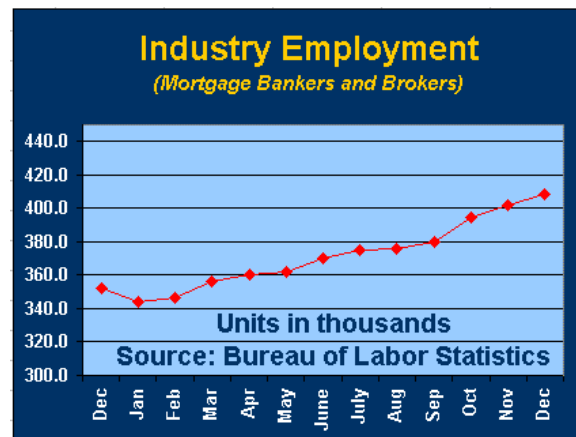
Credit, war, economy, and El Nino are not the key long term variables in resale housing growth. If you plot interest rates, GNP growth, unemployment and even war against the long term data on existing (not new construction) home sales you find that these are not the primary drivers of home sales volume. The reason is simple, **housing is like oxygen. While housing may be a good investment, people buy homes because they need a place to live.** Life change events like babies, marriage, retirement and merit salary increases are the primary drivers behind home buying. Housing: you just gotta have it!

New construction is different. It IS impacted by everything: GNP, interest rates, building materials, labor costs and weather. My focus is resale homes and the mortgage sector, so let me defer any new

construction prognostication to the experts at the National Association of Home Builders.

While the home price bubble may not burst, let's not forget mortgage servicing and the retail channels, the lender's own branch operation and independent mortgage brokerages.

If and when the seemingly permanent refi boom ends, I see a cataclysmic reduction in employment in mortgage brokers. **When interest rates rise, more than half of the mortgage origination and processing employment will blow away in the dust.** It has happened before, though not as dramatically as can be expected this time.



This chart demonstrates that tremendous growth in mortgage lending employment has continued throughout 2002.

However an interest rate rise don't seem anywhere in the offing, but even if rates stay stable surely the volume has to shrink eventually. In time, every borrower, even those with 550 FICO scores will have refinanced and re-refinanced.

At that point, lenders own retail channel will also shrink, but slower than the brokers resulting in market share gains. And once the refi boom is over, lenders will uncover a new/old channel: Realtors. The easy money of the refi boom has caused

mortgage brokers to neglect their historically close relationship with real estate agents - their primary source of referrals. Look for lenders to rediscover Realtors late this year.

After mortgage brokerage gets decimated, lenders will have mixed feelings on what comes next. Obviously origination income shrinks. On the positive side, **servicing portfolios will get some stability, impairment charges (the downside of the refi boom) will return to normal and servicing may get back to profitability if average loan life rises above four year break even level.** As the flood of applications abates, I hope lenders will become concerned with retention, which is a miserable 7%. **Yes, today, 93% of mortgage borrowers DON'T stay with their current lender when they borrow for their next home. Only the funeral industry has lower customer retention rates!** Customer retention is the "low hanging fruit" for lenders looking for a "new" channel. Two lenders, Chase and CitiMortgage are very forward thinking in this area, and they are implementing programs that maintain relationships with their borrowers, as well as tools that detect when a loan is "at risk" of runoff, whether due to refinance or purchase prepay. Note that Chase and CitiMortgage are Domania clients.

Back To Real Estate

But, let's get back to real estate. Just as the new car market is supported by a healthy secondary or used (excuse me "pre-owned") car market, likewise, growth in the housing market depends on first time or new home buyers. First time buyers nip at the heels of current owners and are the fundamental engine of volume growth in the resale market.

Up is Not Down! It's Different.

In analyzing the risk that the bubble will burst, I believe that people confuse the factors behind price increases and price declines. Different forces drive prices up and down. Let's disaggregate the reasons behind home price rises and falls. While fear and greed are part of the equation, price rises are mostly rational, while declines (or the lack of) is irrational. **Price increases are driven by excessive demand, low interest rates (the real lever on housing prices), and recently, the excess cash** injected into the economy from stock market profit taking. Price declines are very different.

A near catastrophe is required to make prices fall. The reason is human psychology. **We are more willing to sell our stock and take profits (upside) than to acknowledge losses (downside).** Prices are very "sticky" (reluctant to fall) in the downward direction. Just as we are reluctant to sell stocks that have lost value, because we figure *"may as well hold, they might go up"*, the same goes for housing. I still own my CMGI stock which costs Fidelity more in stamps on my statements than the shares are worth. Consumers are very reluctant to recognize losses

unless a catastrophe hits us over the head and says that there is no prayer of a recovery in the near future. Prices dropped in Massachusetts in 1990, and there was a sharp drop in Southern California prices in the early nineties. Low rates notwithstanding, we should have had a price decline starting a year ago. But we are all stubborn about recognizing losses.

Now, let's get back to sex in foreign countries to illustrate why home prices won't fall. **I don't believe there will be a housing price bubble because the key driver of primary demand is untouched: the flood of immigration to the US continues unabated.** This keeps the market flush with first time buyers who come in at the bottom, and support the market as they move up. They comprise roughly 11% of all resale home transactions. Let me give a brief history of immigration to bring focus your attention on demographics, and help you understand the impact on housing.

Domestic Stability

Back in 1957, the population was 171 million and the Elvis had two top ten hits. My parent's generation was apparently weak at math, and the US birth rate reached its high point at third world levels: an average of 3.8 children per woman. Today, the country has 100 million more people than in 1957!

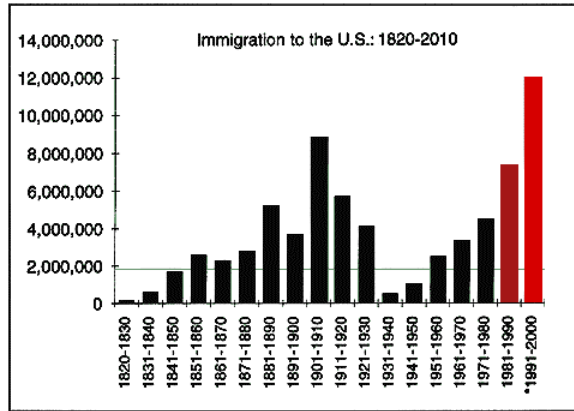
In 1980, I was in my first house, and the US population was 226 million. The eighties added twenty-two million souls. By comparison, it was only 203 million souls ten years earlier. The growth of the eighties was like adding an additional Atlanta and all of its sprawl every two years! That gets a homebuilder salivating, and an environmentalist crying!

However, 1990 was a milestone year. Although the population reached 250 million - up a whopping 47 million from 1970, the US came close to stabilizing the population. Families had just 1.9 children - right around the stable replacement level. Perhaps our bedroom math skills improved and couples were able to calculate that college and food bills cost more for three kids than two!

Also, in 1990 I was on my third house. Home prices had just fallen by seven percent in Massachusetts, and it took five years to recover my loss. Domestic population stability was overshadowed as immigration rules loosened and the floodgates opened for legal and illegal immigration. During that 1990s, the immigrant population increased by 57% to 19 million. And the foreign born proportion of the population rose to almost 8 percent. Over one third of population growth in the 1990s was due to immigration.

Immigration added 1.1m immigrants annually in the 90s. Further, the higher immigrant birth rate

compounds the effect of immigration beyond the first order effects.



Today, almost 11% of the US population is foreign born, and the forecast for legal immigration in the next FIVE years suggests that we will add another 10 million. With new home construction at just over one and a quarter million units a year, we can expect that immigration is filling half of the future new home demand pipeline. If immigrants.

All States Are Not Equal

In the 1990 census, six states held 75% of the immigrant population, but only 39% of the housing stock. Immigration (and home building?) is concentrated in California, New York, Texas, Florida, New Jersey and Illinois. Other states are affected by migration whether it is foreign, domestic snowbirds or California escapees.

Did you know that Massachusetts has more people per square mile than Haiti? Or were you thinking of moving to Colorado? The influx increased Colorado's population by one million (1,017,488 to be exact) in just TEN years. A 22 31% increase in ten years. Once pleasant Fort Collins has suffered 28,000 new residents in the last ten years. So what do Realtors think about growth? I remember asking the head of a large real estate brokerage in Fort Collins to compare the housing market in growth-conscious Boulder with his town. The confident answer was that his practice would thrive with or without limits. Growth controls certainly raise house prices, and thus the commission on a side whereas new construction increases salable inventory.

Do you plan to move to Missoula? Do your kids plan to get a job in Idaho Falls? Doubt it. Fort Collins notwithstanding, they are more likely to move to Washington, DC, Phoenix or Las Vegas. The National Geographic depicts bison as standing in a vast emptiness, and we know that America is a country of wide-open plains, and infinite space. However, you, me, our kids and immigrants are not headed to North Dakota. We are moving to Walnut Creek, Colorado Springs, Bethesda, Norcross and Jacksonville. Are you planning to move to a "fly fishing" state where the cows outnumber the people?

National Origin

For years, the National Association of Realtors has promoted the immigrant market opportunity to its aging membership. Roughly one third of homes sold were to first time home-buyers, and in turn, about 1/3 of first time buyers were immigrants. Like the NAR, the Mortgage Bankers Association, FannieMae, FreddieMac, every major bank and myriad federal programs provide initiatives to help immigrants become homeowners. In his address to the MBAA's recent convention in Chicago, HUD Secretary Martinez's speech focused not on programs for Americans, but on a Peruvian family that achieved homeownership less than two years after their arrival in the US. These exhortations are well rooted in statistics. In 2000, Mexican immigrants were the largest group, comprising just over a quarter of the foreign born residents. China, the Philippines, India, and Cuba, El Salvador, Vietnam and Korea provided another quarter.

Of the 6m homes sold each year, about 10% of the market or 600,000 homes are sold to immigrant first time buyers. If immigrant home buying is concentrated in the resale sector, not new construction, then immigration is even more important to the resale market, being perhaps 12% of the total. This is a market where prices and growth are sensitive to new customers, including foreign ones.

Immigration Vs. Home Ownership!

Last week, I hid in a cave for my quadrennial immersion deep in the minutia of housing stats. The state variations in homeownership fascinate me, and I am used to New York being at the bottom (Big Apple apartment dwellers?) and West Virginia near the top (affordability trumps growth). What surprised me was that home ownership in California a top immigrant destination, was an astoundingly low 58% - ten points below the national average. Looking deeper, I found that there is a correlation between low home ownership and the double-digit immigration states (immigrant population above 10%.

State	% Ownership	% Foreign Born
US	68%	11%
DC	43%	13%
NY	54%	20%
HI	56%	18%
CA	58%	26%
RI	60%	11%
MA	61%	12%
TX	64%	14%
NV	65%	16%

Although there is a correlation, this does not prove causation. What is the cause of low home ownership rates in the top immigration destinations? Does immigration push up the demand side and put pressure on prices that makes housing unaffordable? Or is there a natural time lag as immigrants build the capital to become homeowners. More study is warranted.

The Wrap Up – Immigration=Demand

We want cheap labor to cut our lawns, prepare our fast food, skin chickens and even build our homes. And immigration provides demand side pressures that support housing growth and the current price levels. Population growth benefits the value of our homes, but devours open space and wills a more crowded America to the next generation. Our children will have to worry about disappearing cornfields in Fort Collins, golden hillsides in Vista, leveled woodlands in suburban DC and filled wetlands in Fort Meyers.

As a key driver of housing growth, and price rises, immigrants and home prices are safe as there is no national plan or consensus to change our immigration policy. There is no likelihood that the gates will be

closed on immigration, a key driver in housing demand.

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