

Wisconsin Economic Forecast

The Real Estate Outlook for 2009, and Beyond

By: Dr. Stephen Malpezzi

One year into our first recession since the 2001 “tech wreck,” we all wonder how this recession will play out. It shows signs of approaching or exceeding the severity of the oil price shocks of 1974 and 1981, and some forecast the worst recession since World War II. As usual, we don’t know much about how this will progress while we’re in it – will a sharp contraction be followed by a rapid expansion, the so-called V-shaped recovery? Or will the economy struggle for several years to overcome the effects of the housing bust and the ensuing financial crisis?

The root cause of our current problems was an over-expansion of the housing market, a run-up in housing prices fueled by low interest rates, and expansion of subprime and other lending, interacting with an ever-tightening regulatory environment for real estate development. (Readers can find several webcasts by UW faculty and others on these events at www.bus.wisc.edu/research/economic_crisis.asp).

This is our ninth recession since World War II. Every business cycle is different, but the majority start with a contraction in the housing market. This feeds into a reduction of consumption. Falling housing investment directly affects purchases of furniture, and other durable goods; a crash in the housing market quickly eliminates substantial numbers of jobs in construction and real estate brokerage; and confidence and financial wherewithal also decline, especially for the purchase of automobiles and other big-ticket items. As consumption, the “Big Kahuna” of the economy, slows, the derived demand for commercial real estate also hits the skids.

The first figure, below, shows the root cause using National Association of REALTORS® data on house prices, adjusted for inflation, along with related data on median household income. Between 1968 and the present day, median household income rose from about \$35,000 to about \$50,000 in constant \$2005. On the other hand, the real median NAR house price rose from about \$91,000 to a peak just near \$220,000 in 2006. It is simply inconceivable that house prices would continue to rise year after year three to five percentage points faster than all other prices, as they did for much of the decade before the 2006 peak. As the late economist Herb Stein was often quoted, “when something can’t go on forever, it will stop.”

The Big Picture

One of the most remarkable successes of the U.S. economy over the past 15 years has been the taming of inflation and the relative stability of nominal interest rates. Remember 15 percent to 20 percent mortgage interest rates during the second oil price shock in the early 1980s? Even today with all the difficulties we have in the economy and the housing market, borrowers benefit from low mortgage rates – if they can qualify.

With house prices falling nationally, it's no surprise that housing starts are anemic. National housing starts are currently running just above 500,000 per year, while before-crash recent averages have been about triple that. This is extremely difficult for those in the construction and development industries, but with the weakness we're seeing in housing prices, a reduction in starts has been a painful necessity.

Even with the recent reduction in starts, housing sales are sluggish and inventory is at levels we haven't seen since the 1980s when we look at the market for new houses. When we see this data turning back towards long run trends (i.e., half a year's inventory, instead of a year or more) we'll find ourselves in a much healthier industry.

How's Wisconsin Doing?

Wisconsin's economy and housing markets have not escaped the pain, but so far we've done better than the nation as a whole on a number of important indicators. In the 1980s the United States as a whole pumped up new housing supply substantially, fueled by the excesses of the Savings and Loan boom. Our lending and development was more conservative, and Wisconsin production lagged behind. We missed the boom in the 80s, but we also missed the bust in the 90s! While much of the rest of the country worked off an overhang in housing (and an even bigger overhang in commercial construction), our housing production steadily increased over both decades. So it's not surprising that we've taken a somewhat bigger proportional hit in new production over the past two years. While this has been painful for our housing producers, it contributed to a somewhat better financial performance of housing markets in Wisconsin compared to the nation as a whole.

Wisconsin has not been immune from the national pressure on housing prices. But the next figure shows you that most of our markets had smaller percentage declines over the past two years than we've seen in the national averages, and certainly better performance than in the highly volatile markets in states like California and Florida. Since their peak in 2006, national housing prices have fallen 20 percent or so on average.

Most of these Wisconsin markets have fallen on the order of 8 percent to 10 percent from their 2006 peaks. Pierce County, with a smaller population and a more volatile housing market that's driven by its much bigger neighbor to the west, has fallen by about 16 percent. Some of the faster growing suburban Milwaukee counties have also been a little more volatile. When you break out Ozaukee and Waukesha from the Milwaukee metro area, these counties have taken hits of about 14 percent. These declines are significant, but even these locations are doing much better than the national average and certainly better than the 30 percent plus hits taken in markets like Las Vegas, Miami and Los Angeles.

That's good news. But it's not clear we're done yet. The turning points in housing market cycles are virtually impossible to estimate reliably. Nationally, we've got a fair number of Alt-A and option mortgages resetting during the next two years. By some measures we might expect the market to hit bottom sometime in the near future as the U.S. market works through another 5 percent to 10 percent price decline. It may well be that we're near the bottom in many of our Wisconsin markets, but frankly it's too soon to tell for sure.

Our housing markets benefited in the 1980s from Wisconsin's somewhat conservative real estate underwriting. We certainly made fewer bad bets on white elephant commercial projects then, and we've underwritten fewer subprime and Alt-A loans now. A few of our metro areas, including Milwaukee, were roughly at national averages for "high rate loans," or other subprime proxy measures. But most of the state's metro areas and counties were usually well below national averages. Broadly, so far we're in the same boat, doing better than average (but not as well as we'd like) on defaults and foreclosures. A few of our local financial institutions have taken significant hits in out-of-state real estate investments, but lending to Wisconsin residential and commercial real estate has so far proven less risky.

Nationally, some markets got into trouble when the housing market got too "frothy." But others, like Cleveland or Flint or Brownsville, got into trouble despite more restrained pricing, because their local economies have been under such extreme stress. Wisconsin certainly has pockets of problems, such as parts of Milwaukee, or the state's Southwest, but as a state so far our economy is holding up rather well. For example, the latest unemployment data put our rate at 5.6 percent of those employed or actively seeking work, a full percentage point lower than the national average, and well behind states experiencing the worst labor markets, like Michigan (flirting with double digit unemployment) or California (at 8.4 percent).

What's the Outlook for 2009?

The good news is that we've suffered through what will probably turn out to be the largest part of the housing correction, and we've done better than most states. The bad news is that the worst may be yet to come for commercial real estate, in Wisconsin as well as the rest of the country. Nationally we're just beginning to see real weakness in the commercial real estate markets, following the downturn in housing and our current weak retail and consumer durables markets. Once again I would expect that our generally conservative approach to development and real estate lending will pay off with more modest losses in this area than national averages, but we won't be immune from the pain.

This is especially true because the next stages of the recession will likely be less localized than the housing bust and the initial stages of our financial crisis. Our housing markets boomed less than some several years ago, and fell less during the past two years as a result. But now that we're facing a broad reduction in consumption, we'll be less insulated by our good behavior this time around. Still, even though we've taken some serious hits like the closure of Janesville's GM plant, we're fortunate that our manufacturing, which leads so much of Wisconsin's economy, is less tied to the auto

industry than our neighbors in Michigan and Indiana. And the weakening dollar that is a side effect of the low rates the Fed is using to fight the slump will help us pick up some manufacturing exports.

These knock-on effects of the housing crisis and the current weakness in consumption will be felt across the range of commercial property types; hotels have been weak for some time, but retail, office and industrial space are all weakening across a range of markets.

Much of how things develop in 2009 and beyond will depend on things that are hard to measure or forecast. Will the Fed and Treasury's activities (dropping rates, the Troubled Asset Relief Program, the initial bailout of two automakers, the Fed's expanded open market activities) begin to get traction? What kind of stimulus package will Congress and the next administration deliver? How will foreign investors respond to declining nominal yields, especially as the dollar resumes its slide? Will we move expeditiously through the outstanding stock of defaults and make good decisions about when to foreclose, when to offer or accept a new deal? Will we come up with a practical plan for Fannie and Freddie? Will lower mortgage rates finally tease more buyers back into the market, in a sustainable way? Most importantly, will we honestly rethink and rectify the moral hazard and incentive issues that are now rife throughout our system? We're not going back to the "It's a Wonderful Life" world of George Bailey's building and loan, where every loan originated is to someone we personally vouch for. But we need to find some ways to give all participants in the modern unbundled real estate transaction some skin in the game of good real estate decisions.

What's the Long Run Outlook?

This is not the most optimistic outlook note I've ever penned. Wisconsin, and the United States – in fact most of the world – faces significant economic challenges over the next several years, and the next decade. But it's important that we not waste the opportunities the crisis presents to us. We can hold our national leaders, on both sides of the aisle, to the fire, to turn this around and to put us on a better growth path. On the regulatory front, the debate about "too much financial regulation" versus "too little regulation" is a red herring. We've had stupid regulation, and that often ineptly and unevenly enforced. We need to cut the Gordian knot that ties up so many loans in foreclosure when some of those loans would better go through workouts. We need to think hard about what kind of mortgage designs should be default choices for typical borrowers, to balance affordability with appropriate risk sharing. We need to get banks and other intermediaries lending again, but with sound underwriting. Closer to home, all of us – professors as well as developers, lenders, brokers, and yes, government officials – have to think hard about how we offer a better and more relevant "value proposition" in these difficult times to those whom we serve.

I'm bullish on the long run. With all the ups and downs, the U.S. economy (and Wisconsin's) has turned in an average growth rate, per capita, adjusted for inflation, of around 1.7 percent, for most of the past century. Those of us who are middle aged have seen our economic output double or more in our lifetime. For most of the 10,000 years

that people have lived in villages and cities and towns, economies have only had cycles and “shocks,” as crops had good years and bad, and wars, disease and extreme poverty took their toll; for most of history growth trends have been so slow as to be almost imperceptible. It took 10,000 years for Wisconsin’s output to go from something like zero to something like \$20,000 per capita; then over the next 50 years, it’s more than doubled to near \$50,000. Along with that growth comes better living standards for ourselves and our children (not least of which is that we’re much better housed). Yes, we have challenges, including some environmental problems that need to be appropriately addressed; long term budget issues as the boomers age and population growth slows down; and social issues, not least how we cope with those who lack the necessary education and skills to take full part in our modern economy. But we’ve done a fair job on some big challenges in the past, once we’re pushed to it; and we’ll do so again.

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A longer version of this article, including more charts, some acknowledgements, and sources, can be found by visiting www.bus.wisc.edu/realestate.

Source: News.WRA.org - January 2009



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