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OPINION

The Housing Crisis Is Over

By CYRIL MOULLE-BERTEAUX

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The dire headlines coming fast and furious in the financial and popular press suggest that the housing crisis is intensifying. Yet it is very likely that April 2008 will mark the bottom of the U.S. housing market. Yes, the housing market is bottoming right now.

How can this be? For starters, a bottom does not mean that prices are about to return to the heady days of 2005. That probably won't happen for another 15 years. It just means that the trend is no longer getting worse, which is the critical factor.

Most people forget that the current housing bust is nearly three years old. Home sales peaked in July 2005. New home sales are down a staggering 63% from peak levels of 1.4 million. Housing starts have fallen more than 50% and, adjusted for population growth, are back to the trough levels of 1982.

Furthermore, residential construction is close to 15-year lows at 3.8% of GDP; by the fourth quarter of this year, it will probably hit the lowest level ever. So what's going to stop the housing decline? Very simply, the same thing that caused the bust: affordability.

The boom made housing unaffordable for many American families, especially first-time home buyers. During the 1990s and early 2000s, it took 19% of average monthly income to service a conforming mortgage on the average home purchased. By 2005 and 2006, it was absorbing 25% of monthly income. For first time buyers, it went from 29% of income to 37%. That just proved to be too much.

Prices got so high that people who intended to actually live in the houses they purchased (as opposed to speculators) stopped buying. This caused the bubble to burst.

Since then, house prices have fallen 10%-15%, while incomes have kept growing (albeit more slowly recently) and mortgage rates have come down 70 basis points from their highs. As a result, it now takes 19% of monthly income for the average home buyer, and 31% of monthly income for the first-time home buyer, to purchase a house. In other words, homes on average are back to being as affordable as during the best of times in the 1990s. Numerous households that had been priced out of the market can now afford to get in.

The next question is: Even if home sales pick up, how can home prices stop falling with so many houses vacant and unsold? The flip but true answer: because they always do.

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In the past five major housing market corrections (and there were some big ones, such as in the early 1980s when home sales also fell by 50%-60% and prices fell 12%-15% in real terms), every time home sales bottomed, the pace of house-price declines halved within one or two months.

The explanation is that by the time home sales stop declining, inventories of unsold homes have usually already started falling in absolute terms and begin to peak out in "months of supply" terms. That's the case right now: New home inventories peaked at 598,000 homes in July 2006, and stand at 482,000 homes as of the end of March. This inventory is equivalent to 11 months of supply, a 25-year high – but it is similar to 1974, 1982 and 1991 levels, which saw a subsequent slowing in home-price declines within the next six months.

Inventories are declining because construction activity has been falling for such a long time that home completions are now just about undershooting new home sales. In a few months, completions of new homes for sale could be undershooting new home sales by 50,000-100,000 annually.

Inventories will drop even faster to 400,000 – or seven months of supply – by the end of 2008. This shift in inventories will have a significant impact on prices, although house prices won't stop falling entirely until inventories reach five months of supply sometime in 2009. A five-month supply has historically signaled tightness in the housing market.

Many pundits claim that house prices need to fall *another* 30% to bring them back in line with where they've been historically. This is usually based on an analysis of house prices adjusted for inflation: Real house prices are 30% above their 40-year, inflation-adjusted average, so they must fall 30%. This simplistic analysis is appealing on the surface, but is flawed for a variety of reasons.

Most importantly, it neglects the fact that a great majority of Americans buy their houses with mortgages. And if one buys a house with a mortgage, the most important factor in deciding what to pay for the house is how much of one's income is required to be able to make the mortgage payments on the house. Today the rate on a 30-year, fixed-rate mortgage is 5.7%. Back in 1981, the rate hit 18.5%. Comparing today's house prices to the 1970s or 1980s, when mortgage rates were stratospheric, is misguided and misleading.

This is all good news for the broader economy. The housing bust has been subtracting a full percentage point from GDP for almost two years now, which is very large for a sector that represents less than 5% of economic activity.

When the rate of house-price declines halves, there will be a wholesale shift in markets' perceptions. All of a sudden, the expected value of the collateral (i.e. houses) for much of the lending that went on for the past decade will change. Right now, when valuing the collateral, market participants including banks are extrapolating the current pace of house price declines for another two to three years; this has a significant impact on the amount of delinquencies, foreclosures and credit losses that lenders are expected to face.

More home sales and smaller price declines means fewer homeowners will be underwater on their mortgages. They will thus have less incentive to walk away and opt for foreclosure.

A milder house-price decline scenario could lead to increases in the market value of a lot of the securitized mortgages that have been responsible for \$300 billion of write-downs in the past year.

Even if write-backs do not occur, stabilizing collateral values will have a huge impact on the markets' perception of risk related to housing, the financial system, and the economy.

We are of course experiencing a serious housing bust, with serious economic consequences that are still unfolding. The odds are that the reverberations will lead to subtrend growth for a couple of years. Nonetheless, housing led us into this credit crisis and this recession. It is likely to lead us out. And that process is underway, right now.

Mr. Moule-Berteaux is managing partner of Traxis Partners LP, a hedge fund firm based in New York.

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