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Is housing out of the woods?

WASHINGTON -- Oct. 24, 2006 -- Depending on whom you ask, the winds may already be shifting for the housing market. All year, economists have warned of a bursting housing bubble and its potential impact on economic growth. However, a recent stream of encouraging data has some prominent prognosticators changing their tune.

One of the first in line was Alan Greenspan. As recently as May 18, the former Federal Reserve chairman put an exclamation point on the housing slowdown when he declared, "The boom is over." But now, the "worst may well be over," Greenspan was quoted as saying Oct. 7, after mortgage applications posted their biggest weekly gain since June 2005.

A growing number of economists and analysts have come around to the ex-Fed chief's view. Some investors may see sunnier skies too, as homebuilding stocks such as Lennar (LEN), DR Horton (DHI), and Pulte Homes (PHM) have rebounded since touching 52-week lows in July. Reports on existing home sales for September, scheduled for release Oct. 25, and new home sales Oct. 26 could shed more light on housing's status.

Leveling out?

While the most bearish scenarios may be becoming increasingly unlikely, the housing market probably isn't out of the woods yet. Even the most upbeat forecasts call for new-home construction to keep declining nearly as much as it already has so far. Meanwhile, underlying economic figures may contradict their milder headlines.

Greenspan's assessment followed on the heels of Fed Vice-Chairman Donald Kohn's suggestion Oct. 4 that "[housing] starts may be closer to their trough than to their peak." The data since then could give bulls even more reason for guarded optimism. On Oct. 17, the National Association of Home Builders' housing-market index rebounded to 31 from 30 in September, snapping a 12-month decline from 68 a year earlier. A day later, a Commerce Dept. report showed housing starts rose 5.9 percent in September, to an unexpectedly strong pace of 1.772 million units.

"The point of maximum deterioration in housing activity has probably passed," says Jan Hatzius, chief U.S. economist at Goldman Sachs (GS), in an Oct. 20 report. "The sharp downturn of the past year seems to have brought total housing starts -- single-family starts, multi-family starts, and mobile-home shipments -- close to the level justified by the underlying demographics."

Permit plunge

Still, Hatzius comes up with plenty of caveats. Housing activity could drop by another 300,000 housing starts, he projects, as homebuilders work off unwanted inventory and buyers shift from single-family units to multifamily and mobile homes. That would come on top of a decline of 400,000 housing starts already, Hatzius says.

Others maintain that the housing downturn still has a long way to go. "Commentary suggesting housing demand is recovering, based on the latest homebuilder and mortgage applications readings, appears to be more wishful thinking than fact," says Keith Hembre, chief economist at First American Funds, in an Oct. 20 report.

Housing may have stabilized somewhat, but it's probably only temporary, according to David Rosenberg, North American economist at Merrill Lynch (MER). The unexpected September surge in housing starts came alongside a 6.3 percent drop in building permits to their slowest pace since October 2001. A decline in building permits has accompanied a rise in housing starts only six times since 2003, according to Rosenberg, and starts fell a month later on five of those occasions.

Grim futures

Rosenberg also differs with Goldman's Hatzius over demographics. "Our research suggests that this housing cycle does not bottom out until starts reach the 1.3 million mark," Rosenberg said in an Oct. 19 report. "So contrary to popular opinion, we are barely in the fifth inning of this down-cycle on the construction front."

So far, futures traders are sticking with the pessimistic view. In afternoon trading Oct. 23, investors were predicting declines over the next 12 months in all 10 markets covered by the Chicago Mercantile Exchange's housing contracts. The composite index is seen falling 7 percent by August 2007, when the one-year contract expires. That's roughly unchanged from what investors expected a month earlier.

Other derivatives traders may also be betting on a deeper slump for housing. On Oct. 11, the lowest-rated subset of the ABX home-equity index touched its weakest price level since it was launched in January, according to London-based Markit, which created the index with CDS IndexCo. The index tracks a basket of credit default swaps on subprime mortgages and home-equity loans.

Circumspect bears

In an Oct. 9 speech, San Francisco Fed President Janet Yellen painted a possibly even gloomier picture. Yellen spoke of a major homebuilder who calls Phoenix and Las Vegas "the new 'ghost towns' of the West." According to Yellen, price cuts "appear inevitable."

Still, there are some glimmers of hope for housing demand. Peter Kretzmer, a senior economist at Bank of America (BAC), points to the University of Michigan's latest consumer-sentiment report, in which the share of respondents indicating that it was a good time to buy a house jumped to its highest level in 14 months.

Meanwhile, some economists are becoming more circumspect in their bearishness. In an Oct. 20 note, Richard Berner, chief U.S. economist at Morgan Stanley (MS), says he still believes the housing slowdown is far from over. "Nonetheless, the latest data suggest that the intensity of the housing decline may be fading somewhat, and with it some of the

concurrent downward pressure on housing prices," he adds. "If so, one of the biggest perceived risks to the U.S. economy may be smaller than feared."

After years of defying naysayers' predictions, the housing market has finally cooled in recent months, by virtually all accounts. However, the debate over when the current slowdown will end may be just beginning.

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