

# **I Was Way Too Optimistic on the Housing Recession**

**by**

**Nouriel Roubini**

**Stern School of Business, New York University**

**([nroubini@stern.nyu.edu](mailto:nroubini@stern.nyu.edu))**

**and**

**RGE Monitor**

**([www.rgemonitor.com](http://www.rgemonitor.com))**

**September 25<sup>th</sup>, 2007**

This author is well known as one of the biggest bears about the housing market and the economy. Indeed, in August of 2006 this author started writing about the coming housing recession and predicted that this would be the worst US housing recession in four decades and that home prices would fall by 20% (See "[The Biggest Housing Slump in the last 40 years](#)"). At that time these dire prediction were views – by consensus economics – as way too pessimistic even if a few other authors – including Robert Shiller and a few others – were as pessimistic about the prospect of housing. Indeed even when the housing recession picked up in earnest in the fall of 2006 the consensus stuck to its view that this was a temporary housing slump and that this slump would bottom out by early 2007.

In March of this year this author published a long paper (with Christian Menegatti) titled "[The Housing Recession is Still Far from Bottoming Out](#)" that predicted a much worsening housing recession through all of 2008. In that paper the prediction was that housing starts – that had already fallen by 38% by January of 2007 to a level of 1.4 million - would fall much further and would bottom out at 1.1 million in 2008. Indeed, by looking at previous housing recession – where the average fall in starts was 51% - it was sensible to be that pessimistic. Again those predictions were dismissed as too gloomy and pessimistic and unrealistic.

But it turned out that I was way too optimistic about housing, not too pessimistic. As recently reported housing starts have now fallen by 42% and now JP Morgan – one of the most respected research houses on Wall Street and a persistent proponent until recently of the view that the housing recession would bottom out – is predicting that housing starts will fall another 25% to a cumulative fall of 56% from peak and will bottom out at 999 thousand units some time in 2008. Compared to my initial March prediction of a bottom at 1.1 million I turn out to be an optimist. And indeed many other research firms (including Goldman Sachs, Citibank and others) are now

predicting the bottom of housing starts at 1 million to 1.1 million units. So what in March was considered as borderline lunatic is now becoming conventional wisdom.

And the same JP Morgan that, throughout 2007, expected that the negative contribution of residential investment to growth would become smaller as the fall in residential investment will taper out (single digit rather than double digit percentage falls in residential investment in 2007-08) over time is now predicting further sharp drops in residential investment. In their latest report – now fittingly titled “No Sign of a Floor for Housing” - they say: “*we also expect the rate of decline in residential investment will accelerate in 2H07. (2Q actual: -11.6% annualized, 3Q forecast: -15%, 4Q forecast: -17%)*”. So, the rate of fall in residential investment – and thus the negative contribution of housing to growth – will be larger for the rest of 2007 according to the most mainstream – and consensus soft-landing – analysts.

Ditto for the predictions of the fall in home prices. When this author first spoke of a fall in home prices of 20% people replied skeptically that home prices had never fallen nationally year over year since the Great Depression; thus, there was no chance of a 20% fall, the consensus claimed. Now that home prices are starting to fall sharply Goldman Sachs is predicting a fall of 15% in home prices. While Bob Shiller is now – correctly – arguing that to bring back the price to rental ratio to its long terms average home prices may have to fall as much as 50%, not just 15-20%, in some areas.

So what was considered a year ago or even six months ago as dire pessimist about housing is becoming now a consensus view. Right now I see housing start falling more than the 1.1 million that Menegatti and I predicted in March as the housing market has deteriorated since then much more than our then dire predictions. Given the continued fall in building permits and in home sales and the massive excess supply of new and existing homes housing starts could bottom out at level close to previous housing recession, i.e. between 800k and 900k. Indeed in the last two housing recessions (the one that reached a bottom in 1981 and the one that reached its bottom in 1991) housing starts bottomed at 837k and 798k units with a cumulative fall since peak of 65% in the 1991 recession. So the JP Morgan forecast that housing will bottom out at 999k with a cumulative fall of 56% may be too optimistic. Even considering long term demographic trends that suggest higher average housing starts this housing recession may end up being worse than previous ones (in terms of peak to through cumulative fall in starts) as the excesses on the up side of the cycle were much larger than in previous housing recession and as the bubbly increase in home prices (almost 100% in real terms between 1997 and 2006) was much larger than in any other US housing bubble in the last 120 years.

So as JP Morgan rightly put it there is “no sign of a floor for housing”. The housing recession will continue throughout 2008 and the fall in home prices will continue into 2009 before any bottom is reached.

And indeed the latest macro news today confirm that the housing recession is getting worse and that it is now threatening US economic growth and rising the probability of a US recession:

[- Existing home sales fell another 4.3%; consumer confidence was down – and more than expected on housing and credit and job woes;](#)

- [Lennar, a major home builder announced its biggest loss in its 53 year history;](#)
- [the Case-Shiller/S&P home price index shows an accelerating fall in home prices;](#)
- [retail sales – that were weak in August look as weak in September as the ICSC-UBS index shows same store sales now falling for two weeks in a row;](#)
- [the Redbook Johnson index shows also serious weakness \(sales up only 1.6% on a year over a year basis, i.e. falling in real terms\);](#)
- [Target and Lowe’s – two major retailers - are now warning of disappointing sales and earnings results.](#)

With lower home prices, lower home equity withdrawal, a credit crunch in mortgage and consumer credit markets, high oil and gasoline prices, falling employment, lower consumer confidence, the saving-less and debt-burdened US consumer – that spent well above its means for years – is now on the ropes and at the tipping point. And if consumers retrench a recession become a sure outcome.

So if today’s indicators are not “fugly” macro news, what do analysts need to realize that the risk of a hard landing recession is now growing by the day?

And the literally plunging figures in new home sales - now down another 8.3% in August alone, the lowest level in seven years - are the last nail in the coffin of a housing market that was comatose until now and is now effectively dead. The only things alive and moving in the housing market today's are the undertakers taking care of a zombie housing market and carrying the coffin.

The stock market is still blissfully ignoring the onslaught of lousy macro news deluding itself that the Fed easing – and more to come – will rescue the economy from a hard landing. But it had the same delusion in 2001 when the S&P500 rallied 18% in April and May on the expectations that the aggressive Fed easing would lead to a second half of 2001 rebound and would prevent a recession. Too bad that the recession had already started in March. It took three months – until June – for the stock markets to lose their delusion and realize that – in spite of a most aggressive Fed easing – the economy was in a hard landing; thus, stock prices started to sharply fall again starting June 2001 after the 18% “sucker rally” of April and May.