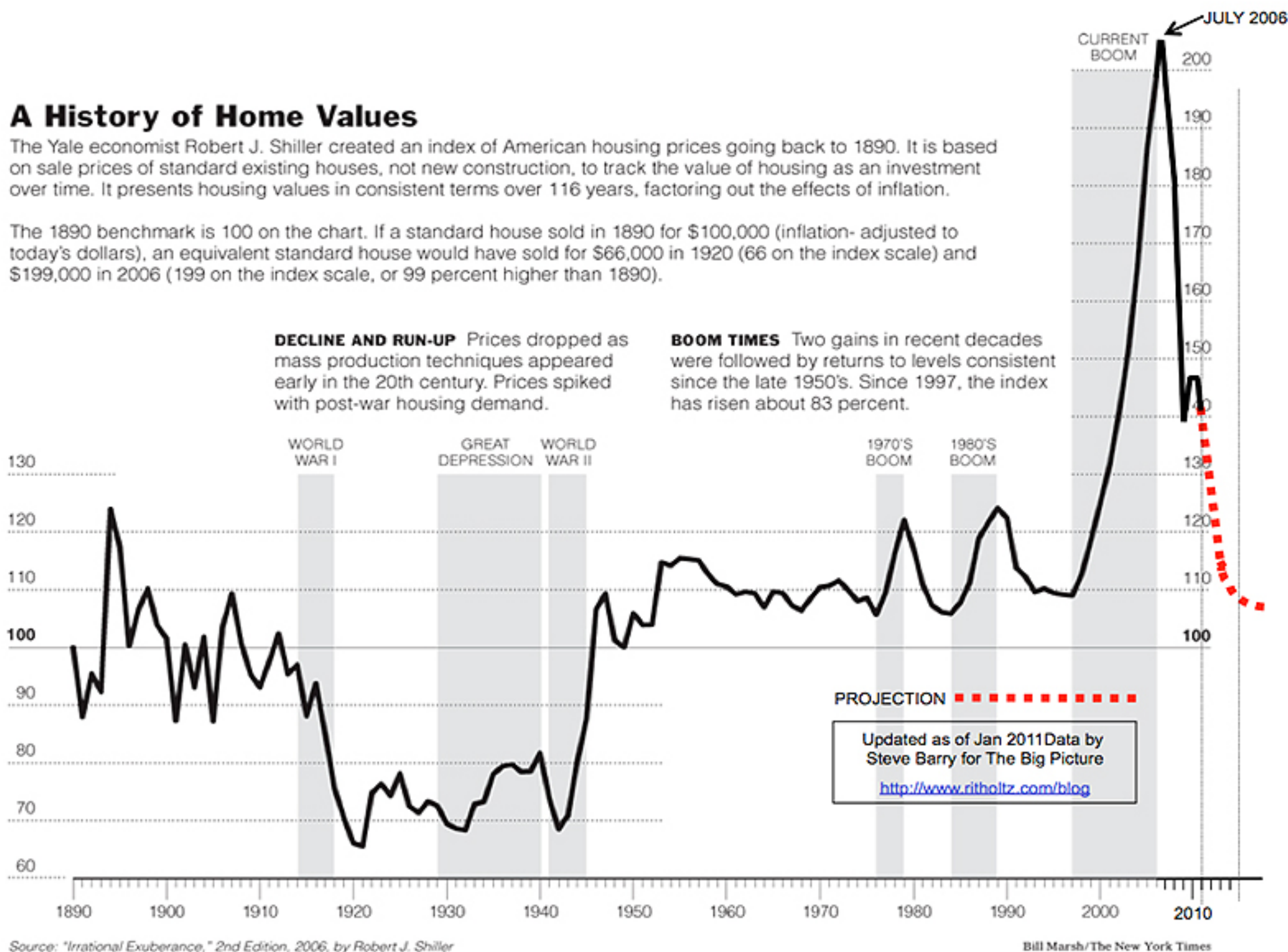
May 13, 2011

Just how out of line are house prices?

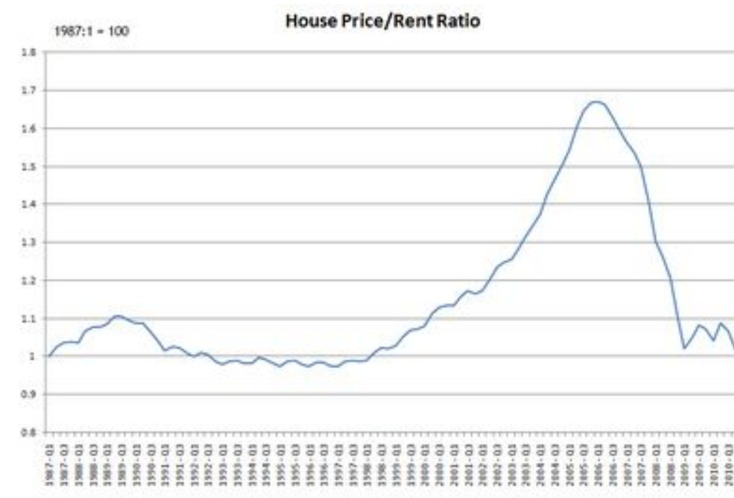
In Wednesday's **post**, I referenced commentary from several bloggers regarding the sizeable decline in housing prices **reported by Zillow** earlier this week. As I discussed yesterday, the rat-through-the-snake process of working down existing and prospective distressed properties is likely far from over, and how that process plays out will no doubt have an impact on how much prices will ultimately adjust.

Recently, Barry Ritholtz's ***The Big Picture* blog** featured an update of a *New York Times* chart that suggests there will be a significant adjustment going forward:



(enlarge)

Prior to the crisis, I was persistently advised that the better way to think about the "right" home price is to focus on price-rent ratios, because rents reflect the fundamental flow of implicit or explicit income generated by a housing asset. In retrospect that advice looks pretty good, so I am inclined to think in those terms today. A simple back-of-the envelope calculation for this ratio—essentially comparing the path of **the S&P/Case-Shiller composite price index** for 20 metropolitan regions to the time path of the rent of primary residences in the consumer price index—tells a somewhat different story than the *New York Times* chart used in the aforementioned Ritholtz blog post:



(enlarge)

According to this calculation, current prices have nearly returned to levels relative to rents that prevailed in the decade prior to the housing boom that began in the late 1990s.

Of course, the price-rent ratio is not the most sophisticated of calculations. **David Leonhardt shows the results** from other such calculations that suggest prices relative to rents are still elevated, at least relative to the average that prevailed in the 1990s. But the adjustment that would be required to bring current levels back into line with the precrisis average is still much lower than suggested by the Ritholtz graph.

How much farther prices fall is, I think, critical in the determination of how the economy will fare in the immediate future. Again, from President Lockhart:

> "The housing sector also has indirect impacts on the economy. In particular, the direction of home prices is important for the economy because changes in home prices affect the health of both household and bank balance sheets. …
>
> "The indirect influence of the housing sector on consumer activity and bank lending would almost certainly aggravate housing's impact on growth."

Here's hoping my chart is more predictive of housing prices than the alternative.

Update: The Calculated Risk blog does a **thorough job** and concludes that we don't have "to choose between real prices and price-to-rent graphs to ask 'how far out of line are house prices?' I think they are both showing that prices are not far above the historical lows."

Update: The Big Picture's Barry Ritholtz points me to **his earlier argument** against reliance on price-rent ratios.

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