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Did They Really Believe House Prices Couldn't Go Down?

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We had a housing bubble and it was huge. (So did a number of other countries.) That is the indubitable fact—it needs a theoretical explanation. The inflation of the U.S. housing bubble lasted six years or so. That is long enough for a lot of people to have made a lot of money from it, but simply to babble "greed" is not an explanation, greed being a constant in human affairs.

In an expanding bubble, belief or "confidence" in the profit potential of the rising price of some favored asset, this time houses and condominiums, seems to be confirmed by success on all sides. While the house prices keep rising, everybody wins—borrowers and lenders, brokers and investors, speculators and flippers, home builders and home buyers, credit rating agencies and bond salesmen, title companies and appraisers, realtors and municipalities, and far from least, politicians. The credit performance of mortgage loans is very good, with very low delinquencies, defaults and losses. More debt seems better. So bubbles are notoriously hard to control.

You can see the bubble in the accompanying graph of the Case-Shiller national house price index. On this measure, U.S. average house prices increased by an enormous 90% from early 2000 to the peak in mid-2006. Since then, they have fallen 27% from the peak, back to about the level of 2003. This is not so bad if you bought in or before 2003 and did not do a cash-out refinancing, but pretty terrible if you bought in 2006 with 95% borrowed money.

We are now two and one-half years into the deflation of the housing bubble with accompanying defaults, foreclosures and massive losses to both lenders and borrowers, as well as home builders, investors and taxpayers. Note that national average house prices have gotten almost back to their longer-term trend line, also shown on the graph. As gravity pulls a thrown object back down, house prices are coming back to their trend: in retrospect, this hardly seems a surprise.

"But," the earnest and rational voice of The American's editor insisted, "did they really believe house prices couldn't go down?"

Indeed, how could anybody believe that the prices of houses don't go both up and down? For that matter, how could anybody believe that the price of anything couldn't go down as well as up? That is the nature of a price.

Yet, let's also remember dot.com stocks. Nothing is more obvious than that the prices of stocks go down as well as up. But we also had a dot.com stock bubble. Its deflation was bad, though not nearly as bad as that of the housing bubble.

Edna St. Vincent Millay was talking about physical attraction in the following verses, but they can equally apply to the emotions of investing and borrowing for speculative capital gains:

> So subtly is the fume of life designed
> To clarify the pulse and cloud the mind.

The speculative pulse is likely to speed up and the mind become especially clouded in crowds. James Grant, that astute and acerbic chronicler of the foibles of financial markets, suggests that "in order to have a really big asset price bubble, a critical mass of human beings is all that's required."

But how about the professionals? Did the financial professionals of the mortgage originating and investing markets, or even more important, of the credit rating agencies who were rating mortgage-backed securities, believe house prices couldn't go down? No, they didn't.

They were well aware that in the last three decades there have been notable housing and mortgage busts, with house prices of formerly hot markets falling and then high defaults and losses on mortgage loans. These occurred in Texas and the other "oil patch" states after the implosion of the 1970s-early 80s oil bubble, in Detroit in the industrial recession of the 1980s, in New England after the technology "miracle," and in Southern California in the early 1990s.

In fact, the severe "oil patch" default and loss experience became a key stress test the rating agencies used in analyzing mortgage pools. The professionals knew very well that the path of house prices is a key determinant of the credit performance of mortgage loans and the securities made out of them. They knew very well that painful housing busts had occurred and assumed they would continue to happen-- on a regional basis.

But it was thought that this would not, and perhaps could not, happen on a national average basis. The U.S. is a truly big country, with an even bigger economy including a great variety of regions and economic characteristics. Oh, national average house prices could go sideways for a while, while general inflation reduced them in real terms, but not actually fall in nominal terms. After all, it was commonly said, they hadn't since the 1930s.

Yes: even the mortgage finance professionals by and large thought that house prices would not fall on a national basis, let alone by 27%. But they did.

A wise saying is, "Many things previously considered impossible nevertheless came to pass." Then we wonder why we considered them impossible. Now to many the recovery of housing and mortgage markets, the banking system and the general economy may seem impossible, but that too will come to pass.

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