3 reasons home prices are heading lower

By Les Christie, staff writerJanuary 1, 2010: 6:22 PM ET

NEW YORK (CNNMoney.com) -- After four months of gains, home prices flattened in October. Worse yet, industry insiders think that they'll soon start to fall.

Prices have risen more than 3% since May, according toS&P/Case-Shiller.

But most forecasts predict price declines in 2010, with possible losses ranging from anywhere from 3% on up. Fiserv Lending Solutions, a financial analytics firm, forecasts that prices will fall in all but 39 of the 381 markets it covers, with an average drop of 11.3%.

"We've seen recent price stabilization because of low mortgage interest rates and the impact of the first-time homebuyers tax credit," said Pat Newport of IHS Global Research. "But there are really good reasons to think prices will now start going down."

There are three main reasons for the reversal: a coming flood of foreclosures, rising interest rates and the eventual end of the tax credits.

More foreclosures

For Gus Faucher, the director of macroeconomics for Moody's Economy.com, the huge number of foreclosures that remain in the pipeline is the big problem.

Moody's upped its estimate of defaults recently because of shortcomings of the government-ledmortgage modification programs. Trial workouts are not being made permanent and completed modifications are redefaulting at high rates.

"There are going to be fewer [successful] modifications than we thought," said Faucher.

Even so, he added, much of the price decline has already occurred and Moody's forecast is for only another 8% drop. The worst-hit markets will be the ones suffering the most foreclosures, places like Arizona, California, Florida and Nevada. (See 7 tips for buying foreclosures)

Resetting option ARMs (adjustable rate mortgages) will also aggravate the foreclosure problem. These mortgages allow borrowers to pick their own payments, which can be so low they don't even cover the interest. Balances swell.

For many of the more than 350,000 option-ARM borrowers, it's time to pay the piper. Their loans will change into fully amortizing mortgages that will carry much higher monthly payments. A very large percentage of these homeowners will default, according to Shari Olefson, author of "Foreclosure Nation: Mortgaging the American Dream."

"We've still only seen the tip of the foreclosure iceberg," she said.

She also predicts more strategic defaults, people deliberately walking away from even fixed-rate mortgages as the value of their homes dips well below the amount they owe.

Olefson's forecast is for price declines of 5% to 15%, depending on the area, with a national median price drop of about 10% for 2010.

Rising interest rates

Also affecting prices will be higher interest rates. Some analysts, according to Newport, think rates for a 30-year mortgage will pass 6% next year as the government curtails housing market support.

The Federal Reserve has helped keep rates low through purchases of mortgage-backed securities. But that program is winding down and will end in March.

"The government is throwing everything at the market but the kitchen sink," said Peter Schiff, president of Euro pacific Capital. "It can't prop up housing markets forever."

Schiff is among the bigger bears. Though he gave no specific prediction, he thinks prices -- already down 29% from the peak -- are only halfway to the bottom.

The end of the tax credit

As a tool for supporting housing markets and prices, the tax credit for homebuyers is a two-edged sword. It reduces taxes dollar-for-dollar by up to $8,000 for new homebuyers and $6,500 for buyers who already own a home and should support home prices. But it ends at the end of April.

Many buyers will push their deals forward to get in before the deadline and then demand for homes could sink afterward.

One of the few bulls out there is NAR, whose chief economist, Lawrence Yun, is counting on the tax credit to provide temporary support for housing markets until the economy recovers enough to start fueling sales. He predicts price improvement in 2010 of more than 3%.

"The headwind we face is rising mortgage interest rates," Yun said, "but the compensating factors will be the homebuyers tax credit in the first half of the year and increased job creation in the second half." ■

http://money.cnn.com/2009/12/31/real_estate/home_price_drop/index.htm