Foreclosures and Residential Real Estate Markets

The number of foreclosures will affect both the timing and the severity of the deflation of the Great Housing Bubble. It is foreclosures that drive prices lower quickly. Foreclosures control the timing of the crash because they directly impact the must-sell inventory numbers: the greater the number of foreclosures, the greater the rate of decline in house prices. By early 2008, most real estate markets had already surpassed the peak set in the price decline of the early 90s of Notices of Default and Trustee Sales (foreclosures).

Lenders faced high foreclosure rates in the early 90s because they were too aggressive with their lending practices in the rally of the late 80s: it was their own doing. Lenders overheated the market then, and they got burned. Apparently, they did not learn the lesson of history.

One of the problems with the collapse of a financial bubble is the causes get incorrectly identified. When the housing market in California collapsed in the early 90s, the recession and job layoffs were blamed for the problems with the housing market. The recession and layoffs came after the housing market was already in trouble. Unemployment slowed the recovery and added to the foreclosure problem, but it was not the primary cause of the entire pricing downturn. The ultra-aggressive lending practices of the Great Housing Bubble caused a huge spike in foreclosures by early 2008. Just as in the early 90s, the increase in defaults and foreclosures is being caused by the past sins of the lenders: karma on grand scale.

The importance of the foreclosures cannot be overstated: sellers do not lower their prices voluntarily. Prices do not drop without massive numbers of foreclosures to push them down. The entire "soft landing" argument boils down to one supposition: the number of buyers in the market is able to absorb the must-sell inventory on the market. If this is true, prices do not drop. If this is not true, prices do drop until enough buyers are found to purchase the foreclosures.

There are always a number of buyers when prices are declining; some are long-term homeowners who are present in any market, but many are speculators betting on the return of appreciation. These people are few in number, but they buoy the market if there are not many foreclosures. If foreclosure numbers really spike, prices fall until Rent Savers and Cashflow Investors enter the market and absorb the excess.

If current trends continue, the number of foreclosures will be too great for long-term owners and speculators to absorb. Foreclosures also control the depth of the decline to some degree. Once prices fall down to their fundamental values, new buyers enter the market and begin to absorb the inventory. If there are not enough buyers at this price level to absorb all the foreclosures, prices could overshoot fundamentals to the downside; in fact, this does tend to happen at the bottom of the real estate cycle.

About the Author

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