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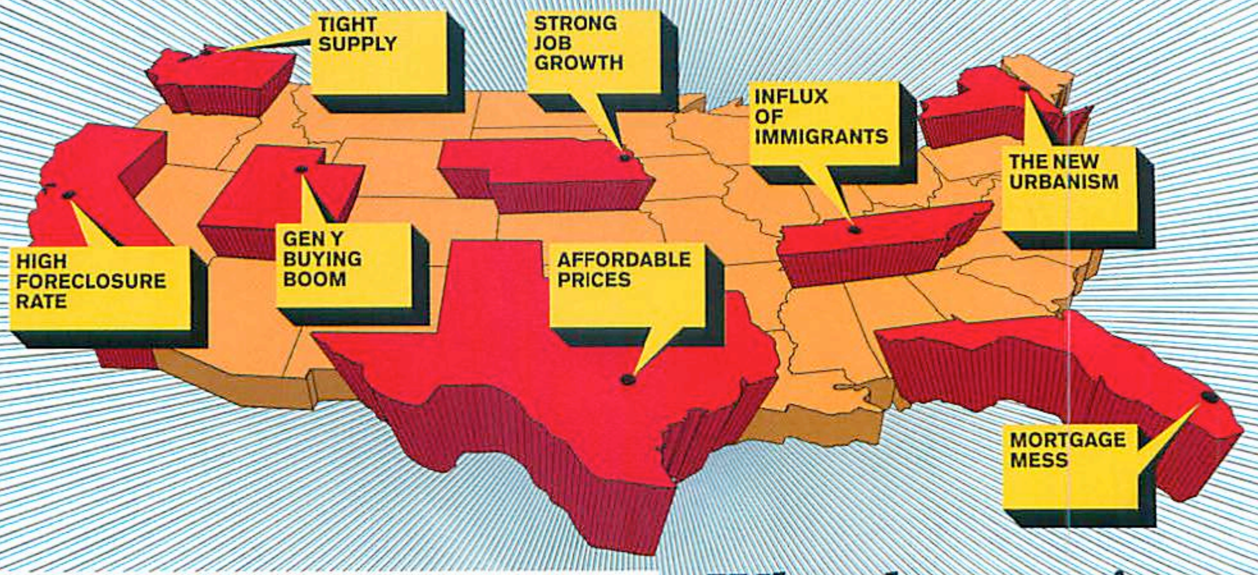
HOUSING MARKET 2012



When home prices will stop sliding—and when to expect a rebound

HOUSING SPECIAL REPORT

WHAT WILL THIS HOUSE BE WORTH IN 2012?

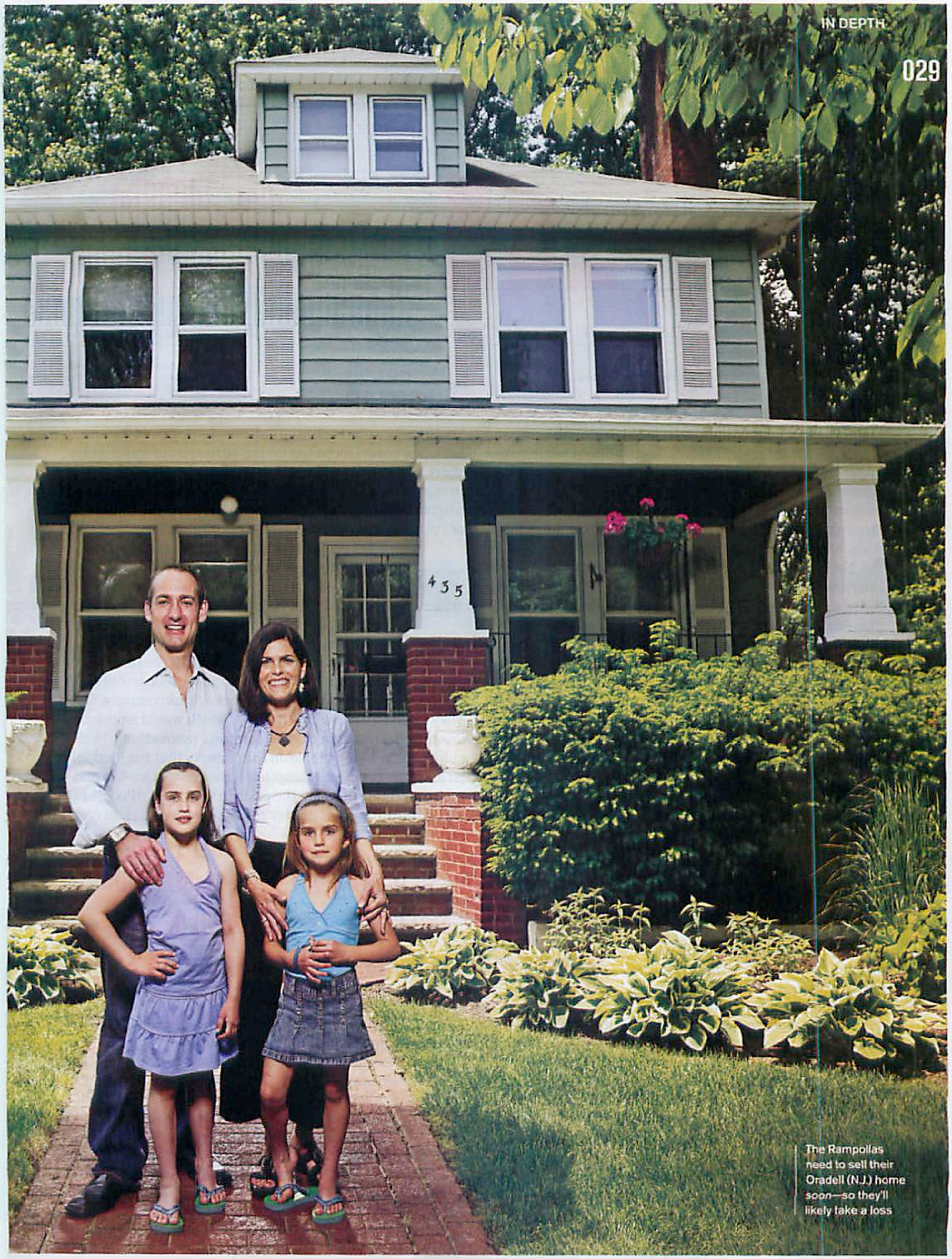
By Peter Coy, Mara Der Hovanesian, Christopher Palmeri, and Amy S. Choi

Home prices may keep falling for the next year, then stabilize and rebound with the economy

Americans have not seen a boring housing market since the last millennium. You know—the average, ordinary kind of market where supply just about matches demand, prices are steady, and real estate ceases to be a topic of daily conversation. Instead, we've had six years of upside craziness followed by three years of downside terror. Now we're in a tug-of-war between those who think we've finally found a bottom and those who are convinced that the overhang of unsold homes is going to push prices considerably lower.

By 2012 we may finally get back to blissful boredom. With any luck, three years should be long enough for the U.S. economy to recover and for the nation's housing inventory to shrink to more normal levels. At that point, housing will return to its old ways, with prices governed not by national mood swings and global credit crises but by local issues

DAVID YELLEN

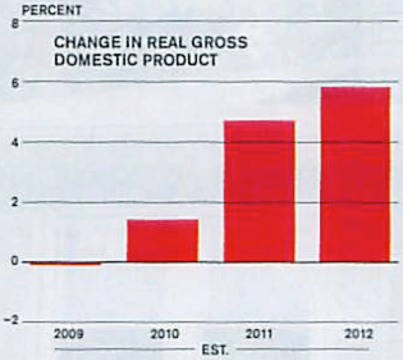


The Rampollas need to sell their Oradell (N.J.) home *soon*—so they'll likely take a loss

THE HOUSING OUTLOOK

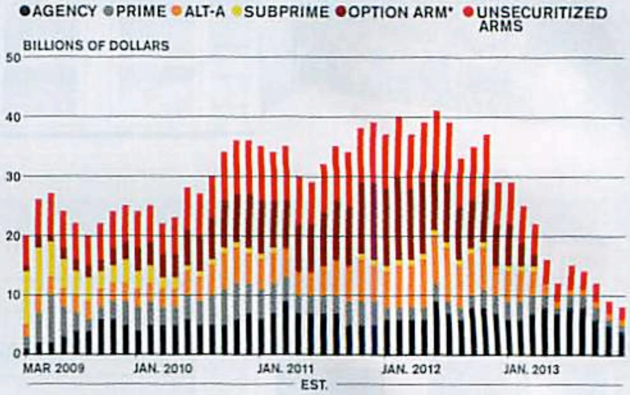
The real estate picture should brighten considerably as the economy strengthens

By 2012 the economy should rebound...



Data: Moody's Economy.com

...and resets of adjustable mortgages should wind down...



Data: Credit Suisse

*Includes only loans originated through March 2009. Does not account for prepayments or foreclosures.

ranging from zoning to immigration to job growth.

Prices? While they're likely to keep falling a while longer under the weight of foreclosures, the market is definitely closer to the bottom than the top. "We expect prices to drop for another year and then stabilize before starting to rise with incomes," says Standard & Poor's Chief Economist David Wyss. Moody's Economy.com predicts the S&P/Case-Shiller U.S. National Home Price Index, maintained by data specialist Fiserv, will fall about 16% this year before regaining ground. Based on the National Association of Realtors national median home price of $180,000 for the fourth quarter of 2008, that would mean a median of $152,000 at the end of 2009 and then a rebound to $179,000 by the end of 2012.

ALL REAL ESTATE IS LOCAL

Of course, the national median price is an artificial construct, since there is no such place as National Median, U.S.A. That's why the following pages provide up-close looks at seven markets: Omaha; Seattle; Saratoga Springs, N.Y.; Salt Lake City; Nashville; Austin, Tex.; and Merced, Calif. Each illustrates a different trend that will have a big impact on sales and prices across the U.S.

Local job growth is one of the most important factors to study when assessing a market's prospects. Omaha, for example, which has attracted employers such as Yahoo! and Google, missed out on the boom but is likewise dodging the bust. With the city adding jobs, the prospects for home prices look good. Detroit, where home prices fell by a third from 2003 through 2008, is likely to suffer even more in coming years as the auto sector continues to shrink. Demographic change, another trend examined here, is equally influential. For instance, Salt Lake City's youthful population is primed for house buying. While the bust left prices in once-bubbly Western markets such as Phoenix and Vegas lower in 2008 than in 2003, Salt Lake prices rose 51% over that period.

Other important factors are even more local than those, such as how far a house is from the nearest supermarket. You'll know we're back to an ordinary, boring real estate market when buyers focus less on the intricacies of foreclosures, short sales, and the like and go back to the things that used to matter most: What are the schools like? How quiet is the neighborhood? When am I going to have to replace that roof or cut down that diseased oak?

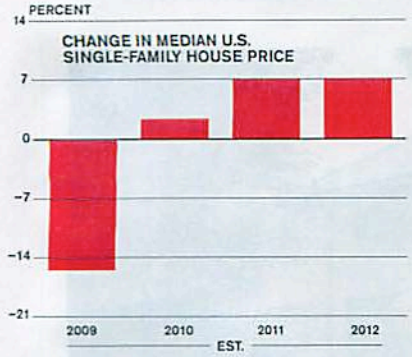
HOW TO PLAY IT 058

Sellers Mark and Maura Rampolla, who put their house in Oradell, N.J., on the market early this year, are coping with ultra-local issues such as their house being on a fairly busy road. They're also up against the national housing crisis angst. The Rampollas bought their house for $556,000 in 2004. Now they need to sell it because they're moving to the Los Angeles area to set up a West Coast distribution hub for their coconut-water sports-drink company, Zico. They listed the house for $599,000, which would represent a loss after factoring in closing costs and renovations. House hunters didn't even nibble on the property that the Rampollas and their two young daughters have grown to love. In mid-June the couple dropped the price to $559,000. "People say it's a beautiful house, but they're just very nervous right now," says Maura.

AS BABY BOOMERS DISCOVER THAT A McMANSION CAN BE A BALL AND CHAIN, THE HIGH END OF THE MARKET MAY KEEP DRAGGING ALONG

The Rampollas will probably end up being the first owners to lose money on the Oradell home since it was built in 1925—a phenomenon that's happening across the U.S. The classic American foursquare, with four bedrooms and original chestnut molding, was sold by the Bonavita family to the Riccio family for $47,000 in 1972, the first recorded transaction price. The Riccios made out by selling to the DeSouza family for $285,000 in 1997. The DeSouzas sold just seven years later to the Rampollas for $556,000. "We actually bought the

...setting the stage for a housing recovery



Data: Moody's Economy.com, Fiserv

For most of its 84-year history, the Rampollas' house gained value

house in a day," laughs Maura. "Mark ran through the house in 10 minutes, I kid you not, because he had to get to a meeting in Queens. ... We had nothing to sell, and we just said: 'Great!' "

The good news is that the Rampollas' loss could wind up being some first-time home buyer's gain. From now through 2012, lots of families that couldn't afford to buy when prices went through the roof will be able to get in on the ground floor. Based on today's household incomes and mortgage rates, the National Association of Realtors' Housing Affordability Index is bobbing around the highest level since recordkeeping began in 1970. "To generalize, yeah, it is a good time to buy a house. I don't think there's any urgency because I think it'll still be a great time to buy a house a year from now," says economist Richard DeKaser of Woodley Park Research in Washington.

Homebuilders are helping by absorbing their share of the pain. In general, the U.S. needs about 1.5 million new homes a year to accommodate the growing population and the demolition of decayed properties. Builders exceeded that rate during the boom, but now they're building fewer than 500,000 homes per year. Their cutback should reduce the glut of homes and bring the market into better balance by 2012, if not sooner.

A STILL-MURKY PICTURE

Most important, the economy should be growing briskly again by 2012, according to Moody's Economy.com. In May the firm predicted gross domestic product would shrink 3% this year before growing 1.4% in 2010, 4.7% in 2011, and a robust 5.8% in 2012. It's also looking for home buying and building to return to their pre-bubble paces—no higher and no lower—by 2012.

Even if the economy performs as projected, there's still plenty that could go wrong in the housing market. Because conditions have been so unusual, "it's very hard for the model to extrapolate, based on past experiences, what's going to happen this time," says Moody's Economy.com Senior Economist Celia Chen. In a study of global real estate markets, economists Kenneth Rogoff of Harvard University and Carmen Reinhart of the University of Maryland found that home prices fall for an average of six years after a major financial crisis. That would put the U.S. bottom in 2012, or later.

Another risk is that potential buyers will stay out of the housing market, no longer trusting in home appreciation to do their saving for them. Writes David Rosenberg, the former Merrill Lynch economist who is now chief economist at Toronto-based asset management firm Gluskin Sheff & Associates: "Baby boomers are still in the discovery process on oversized real estate being more of a ball and chain than a viable retirement investment asset." Rosenberg also is concerned that an aging population won't need the kind of big houses erected during the boom. "The high end of the market will be in a bear phase," Rosenberg says in an interview.

So much has gone wrong with housing lately that it's easy to imagine worst-case scenarios. But in the more likely case, the market will fall some more, bounce off its lows, then gradually start growing. By 2012, families like the Rampollas may even get a warm, fuzzy feeling about homeownership again. |BW|
-With Tara Kalwarski

PHOTOGRAPH BY DAVID YELLEN; CHARTS BY RAY VELLA/BW

BUSINESSWEEK.COM | The Housing Special Report continues online. For a look inside the Rampolla home in Oradell, N.J., watch a video at businessweek.com/go/09/housing. Or check out a market snapshot of the 50 largest metro areas at businessweek.com/go/09/2012

Business Exchange

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The Global Picture

Like the U.S., the global real estate market will continue to struggle amid a weak economy and rising unemployment, according to a recent report by research firm Knight Frank. The worst-performing markets over the past year: Dubai and Singapore, where home prices dropped 32% and 23%, respectively. Israel (up 10.9% over the same period) and the Czech Republic (up 9.9%) saw the biggest spikes.

To read highlights from the report, go to **bx.businessweek.com/housing-market/reference/**

OMAHA: WHEN JOBS ABOUND

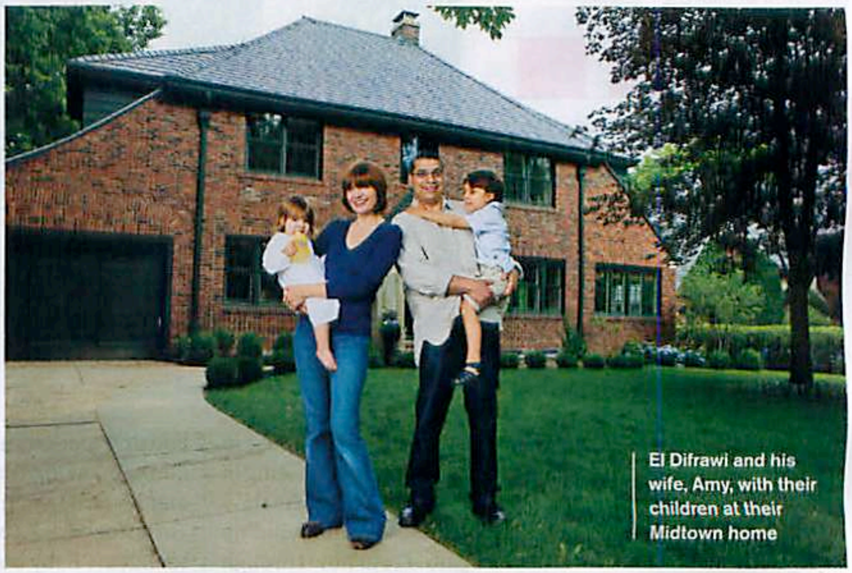
Employment is up and home prices stable as high-tech companies flock to Warren Buffett's city

POPULATION
822,549

2007 MEDIAN HOME PRICE
$138,930

2008 MEDIAN HOME PRICE
$138,000

Numbers reflect metropolitan area
Data: Fiserv



El Difrawi and his wife, Amy, with their children at their Midtown home

THE EMPLOYMENT FACTOR **Where jobs increase, prices likely will follow. Omaha's ultra-low unemployment rate will help boost the local housing market. But with carmakers in shambles, Detroit and other cities with devastated job markets will take longer to recover.**

Local residents joke about the real estate market in Omaha. "We didn't get invited to the party," they say, "and we don't have a hangover." The proof: Prices slipped less than 1% in Nebraska's biggest city last year, compared with an 18% drop for the U.S.

Now Omaha looks poised to tromp the U.S. on the upside. While responsible lending practices and a dearth of speculation have supported the market in recent years, jobs will make all the difference in the future. Unemployment in Omaha hovers around 4%, less than half the national average. Last year Omaha added 2,700 new jobs as the U.S. lost 3 million. The continued strong prospects for job growth in Omaha means prices should rise faster than the U.S. average. The outlook is similar for Sioux Falls, S.D., and the Dallas-Fort Worth region, where unemployment also remains low.

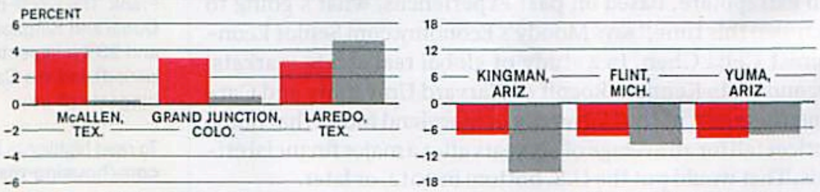
The strength of those markets stands in stark contrast to Detroit and Cleveland, where prices have tanked 44% and 22%, respectively, from their peaks. And the cities' high unemployment could depress housing prices for a while. Cleveland's jobless rate tops 9%, and Detroit's is 13%.

Meanwhile, high-tech companies are flocking to the Omaha area, which boasts an abundance of land and power, an extensive fiber-optic network, and a favorable tax regime. Yahoo! is opening a customer care center. Google just set up operations across the river in Council Bluffs, Iowa. Joseph W. Farrelly, chief information officer of Interpublic Group, says the advertising company will save 25% on salary and real estate by consolidating its global data centers in Omaha. "Omaha's sort of a diamond in the Midwest," he says. "You think it's going to be cornfields. But it's progressive."

Ash El Difrawi relocated to Omaha from Chicago last year to take a job as chief marketing officer at NetShops, an online retailer founded in 2002. At first, 42-year-old El Difrawi, a former consultant at McKinsey and executive at Google, was reluctant to move, but he changed his mind after discovering the vitality of the business community. El Difrawi and his wife, Amy, settled on the historic Midtown area. Last summer they paid $345,000 for a 3,000-square-foot Tudor home. Their new Midtown neighbor, Berkshire Hathaway's Warren Buffett, bought years ago, paying $31,500 for a house that's worth at least 20 times that now. "I'm banking on the area holding its value," says El Difrawi, sounding more like the legendary investor.

JOB CREATION

The best and worst U.S. job markets in 2008*

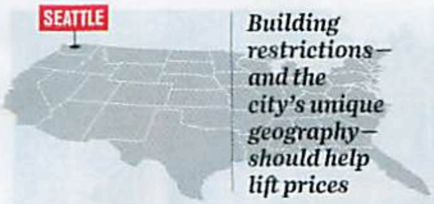


Data: Bureau of Labor Statistics, Fiserv

*Numbers reflect metropolitan area

(LEFT) PHOTOGRAPH BY ALYSSA SCHUKAR; CHART BY RAY VELLA/BW

SEATTLE: LOW INVENTORY



Building restrictions—and the city's unique geography—should help lift prices

POPULATION
2,496,619

2007 MEDIAN HOME PRICE
$437,920

2008 MEDIAN HOME PRICE
$395,000

Numbers reflect metropolitan area
Data: Fiserv

The Hoffs at their new home. Their old one sold above its list price

TIGHT SUPPLY Metropolitan areas such as Seattle and Portland, Ore., didn't experience the rampant overbuilding that happened in Miami and California's Inland Empire. As a result, the Northwest cities should recover faster than others.

Two big factors will help bolster Seattle housing prices in the next few years: stringent building restrictions and basic geography.

City officials kept a tight rein on development during the boom. Much of the new housing consists of "in-fill" projects that replace existing buildings or other properties. For example, South Lake Union, a multi-use development with 2,800 residential units so far and Amazon.com's new headquarters, was built on a former industrial site. "It's a difficult market to penetrate from a land acquisition perspective," says local builder Peter DelMissier, division president of Pageantry Homes. Not that there's much undeveloped land to buy. An isthmus, Seattle is hugged by the Puget Sound on the west and Lake Washington on the east.

With such constraints, Seattle doesn't have a significant supply of homes on the market. It would take just five months to work through the excess inventory, compared with roughly nine months for the U.S. as a whole, according to the National Association of Realtors. "Given sales, demographics, and job growth, we expect the inventory in Seattle to burn off faster than in other markets," says Richard M. Gollis, founder of The Concord Group, a consulting firm in Newport, Calif. Generally, cities with low inventory will bounce back sooner than the rest of the U.S. Tight supply in Seattle—much like in Dallas, Denver, and Portland—should set the stage for recovery in the next year or so.

Homeowners in Miami aren't as lucky. Builders in the coastal city slapped up condominiums and houses during the boom, figuring investors and retirees would jump on them. Today half-built condos mar the skyline, and newly constructed developments sit empty. The area has more than a 40-month supply on the market—among the highest in the country. Atlantic City and Las Vegas also are plagued by excessive inventory. The overhang in those markets will continue to weigh on prices for years, even as the rest of the country recovers.

Some areas of Seattle are on the mend already, with houses even sparking bidding wars. In April, Jen Hoff, 39, and her husband, Pete, 37, decided to upgrade to a bigger house to accommodate their expanding family. They put their Craftsman-style bungalow, typical of the homes in Seattle's oldest neighborhoods, on the market, and received five offers the next day. A few weeks later they sold their starter home for $406,500, roughly $7,500 above the listing price.

The family moved in May to a $569,500 four-bedroom brick home built in 1947. Their new place is only one street away from the old—so Pete Hoff, a statistics professor at the University of Washington, can still bike to work. "We love the character of the neighborhood and that it reflects a time when it was first built," says Jen Hoff, a stay-at-home mom with two sons, ages 2 and 11. "It's not a neighborhood in transition."

U.S. HOUSING GLUT

*Rolling three-month average of existing home inventory
Data: National Association of Realtors

(RIGHT) PHOTOGRAPH BY BRIAN SMALE; CHART BY DAVID FOSTER

SARATOGA: THE ANTI-SUBURB

Urban planners predict a flight to cities with a small-town feel where you can walk to work and to shops

POPULATION
850,957

2007 MEDIAN HOME PRICE
$208,540

2008 MEDIAN HOME PRICE
$206,000

Numbers reflect metropolitan area
Data: Fiserv

Cannizzo, an ex-Manhattanite, likes the sense of community

NEW URBANISM **In a rejection of suburban sprawl, homeowners may be drawn to such towns as Saratoga Springs, N.Y., where they can live and work. Meanwhile, far-flung exurbs like those in Kane County, Ill., and the outskirts of Scottsdale, Ariz., will struggle to attract new buyers.**

Saratoga Springs is anti-suburbia. In this town of 28,500 that's part of the Albany area, boutique shops, not chain stores, dominate downtown. Natural spring water flows from the public fountains. Some residents walk to work. "Architects and planners got together with local politicians to make sure we stayed vibrant to compete" with other communities, says Daniel Neary, a local architect.

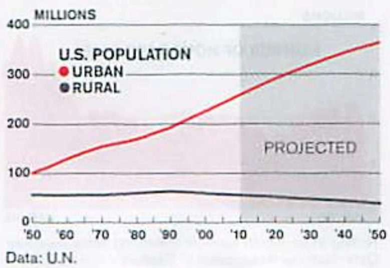
Just as the boom years bred car-centric subdivisions and strip malls, the bust may lead buyers to cities and towns centered on a commercial, retail, and residential hub. That should be a boon to places like Saratoga Springs and Kentlands, an enclave of Gaithersburg, Md., that typify this "new urbanism" model. What makes a city livable, says urban planning and policy expert Robert E. Lang, is "the ability to walk and not drive to go pick up the basics in your life." James Kunstler, the anti-sprawl prophet and author of *The Geography of Nowhere*, lives in Saratoga Springs.

Prices in those communities will get a boost as buyers eschew the exurbs in more rural locales in favor of urban centers. The U.N. predicts rural environs in the U.S. will shrink by almost 2 million people between 2010 and 2015. In the face of the bust, home values in the Saratoga Springs area have held up well, falling just 1% in 2008; and prices should continue to rise steadily as the area attracts families like the Longs. Kristen Long, 40, and her husband, Jeff, 38, traded a seven-acre horse farm near Rochester, N.Y., for a $300,000 custom-built three-bedroom home near Saratoga Springs. "We are so close to great shopping and restaurants," says Kristen. "It's quaint, and you feel comfortable and safe."

When gas was cheap, the remote suburbs of Chicago, Scottsdale, and Las Vegas made more financial sense. Homes in those areas sold for a fraction of their city equivalents. And suburbanites readily drove 20 minutes to a supermarket or commuted 90 minutes to work. Then gas prices surged and the economy soured, crimping housing demand in exurbs. Even though gas prices have since fallen, those markets likely won't see boom-level prices for many years. In Kane County, Ill., empty McMansions sit beside soybeans fields. Local corn and soybean farmer Steve Pitstick says housing contractors are offering to help plant his crops and do other odd jobs. He hasn't had much work for them. "The economy imploded, and everything stopped," he says.

Manhattan transplant Jeffrey Cannizzo moved to Saratoga Springs, home of the eponymous race track and Skidmore College, for a change of pace. Cannizzo, a former manager at Microsoft who now heads a horse-racing trade group, wanted a small-town feel. After renting for a while, the 30-year-old started looking to buy in February. He recently bid $302,000 for a four-bedroom colonial two miles from his office, and the offer was accepted. Cannizzo likes the town's neighborliness: "People here are involved far more than in other communities I've been around."

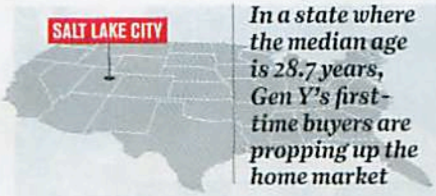
RURAL RETREAT



Data: U.N.

(LEFT) PHOTOGRAPH BY CHRIS CASABURI; CHART BY ALBERTO MENA/BW

SALT LAKE: A YOUTHQUAKE



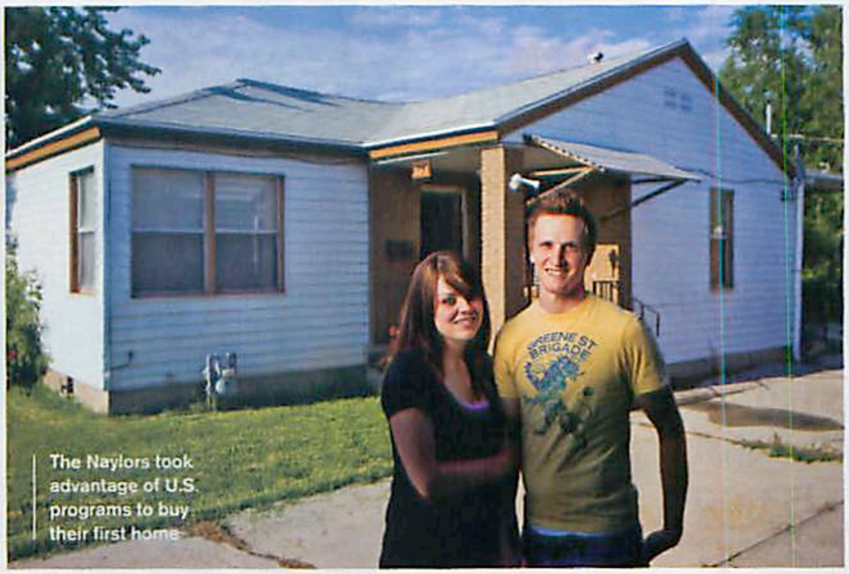
In a state where the median age is 28.7 years, Gen Y's first-time buyers are propping up the home market

POPULATION
1,067,722

2007 MEDIAN HOME PRICE
$238,020

2008 MEDIAN HOME PRICE
$230,000

Numbers reflect metropolitan area
Data: Fiserv



The Naylors took advantage of U.S. programs to buy their first home

YOUNG BUYERS Millennials buying their first home will help drive demand in the coming years. That's good news for Salt Lake City, Raleigh, N.C., and Colorado Springs—U.S. cities with young populations. States such as Iowa and North Dakota are aging.

Salt Lake City is one of the fastest-growing metropolitan areas in the country. But unlike other booming locales, Salt Lake has a largely homegrown citizenry—locals account for 88% of population growth. "Salt Lake City has a high rate of natural increases," says Robert E. Lang, director of urban affairs and planning at Virginia Polytechnic Institute. "It's a big family-friendly kind of place."

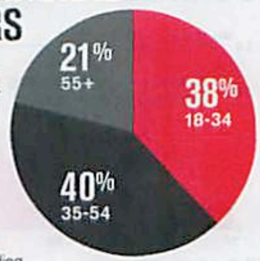
The result is that Salt Lake City has a large and expanding pool of ready home buyers: Millennials, the generation born from the early 1980s to the '90s. Utah, where the Salt Lake environs account for the bulk of the state's residents, is the country's youngest state, with a median age of 28.7 years, compared with 35.3 years for the country as a whole. Raleigh, San Antonio, and Colorado Springs also have youthful populations, whereas states such as Iowa, North Dakota, and Pennsylvania are aging fast.

The Millennials, aka Generation Y, will be one of the most powerful demographic forces to enter the housing market in the years to come. By some estimates, they're expected to account for a third of all home buyers by 2015. They're already out in droves, taking advantage of the $8,000 federal tax credit for first-time home buyers. "A huge cohort of first-time buyers will be in the market in the next five years," says David W. Berson, chief economist at PMI Group, a company that covers banks against borrower default.

Gen Y buyers already have helped prop up the housing market in Salt Lake City. Home prices rose 51% from 2003 through 2008, compared with a roughly 2% drop for the U.S. as a whole. The young buyers' impact is reflected, in part, in the type of sales: The low end of the market, say local real estate agents, accounts for much of the activity, while some multimillion-dollar homes have been sitting vacant for more than a year.

GENERATIONAL FACTORS

HOMEBUYERS BY AGE IN U.S.*
2008



*Does not equal 100 due to rounding
Data: National Association of Realtors

Many properties "weren't available to first-time home buyers a year ago," says Kevin Coyle of Stonebrook Real Estate in Salt Lake. "With the downturn, they can now get something they can afford."

When Gen Yers James and Carleigh Naylor got married last October, the couple moved into a dingy basement apartment they rented from an elderly man who lived upstairs. "It wasn't glamorous," says 24-year-old James, who works as a cabinet maker at his father's shop. Earlier this year the young couple decided to buy their first home, a two-bedroom, one-bath on a cul-de-sac on the south side of town. They beat out six offers with a bid of $137,000—still well below the $230,000 median home price in Salt Lake.

Like many first-time buyers, the Naylors are tapping the new government programs designed to spur home sales. Along with the tax credit, they qualified for a federally backed mortgage, which requires less money up front. And a gift from relatives covered their closing costs and down payment. Says James: "We're hoping to use this house as a stepping stone to get us into the next house three or five years from now."

(RIGHT) PHOTOGRAPH BY LANCE W. CLAYTON; CHART BY ALBERTO MENA/BW

NASHVILLE: NEW ARRIVALS

The city's Kurdish immigrants are helping to stabilize housing prices

POPULATION

1,455,097

2007 MEDIAN HOME PRICE

$159,490

2008 MEDIAN HOME PRICE

$153,000

Numbers reflect metropolitan area
Data: Fiserv

Muhammad, Barwari, and their family at the home built by Habitat for Humanity

IMMIGRANT IMPACT An influx of Kurds and other immigrants is boosting Nashville's population and should be a strong driver for housing prices. But the market is hurting in Danbury, Conn., where some Brazilians are defaulting on subprime mortgages and switching to rentals.

Say Nashville, and most people think of country music and the Grand Ole Opry. But Music City U.S.A. is also home to one of the largest Kurdish populations outside the Middle East. The wave of immigration started after the first Gulf War in the early 1990s. Since then, the Kurdish community has swelled to more than 8,000 people, adding to a foreign-born population that's approaching 10% of the city's population.

More immigrants are purchasing homes, making them an important factor in the housing recovery. As a group, they increased their homeownership rate from 46.5% in 1995 to 53% in 2008, according to the think tank Pew Hispanic Center. And they'll likely continue purchasing. "When you have a 70% homeownership rate among [the] native born, they don't have as much upside," says Rakesh Kochhar, associate director for research at Pew. "Immigrants have room to grow."

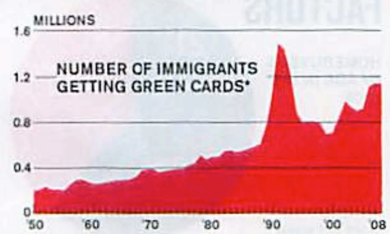
The immigrant population has been a stabilizing force in Nashville, where mosques and markets occupy a stretch of Nolensville Road south of downtown. Already, housing is showing signs of life: Home sales topped 1,300 in April, up from 850 in January. And the fast-growing group of immigrants, like those in Columbia, S.C., and Raleigh, N.C., should help buoy prices in coming years.

An influx of immigrants can be a double-edged sword, however. Consider Danbury, Conn. During the housing boom, Brazilians flocked to the town, helping to revive the former hatmaking capital of the U.S. But many Brazilians in Danbury took out subprime mortgages. Now, 212 borrowers are in default or foreclosure, according to research firm RealtyTrac. That's a lot in a city with roughly 25 home sales a month. Meanwhile, some Brazilian residents are switching to rental properties or moving back to their home country, which will hurt home prices as well.

Toxic mortgages are less of an issue for Nashville's Kurds. They are forbidden by their Muslim faith from paying interest on a loan. Many potential buyers in the community are instead turning to Habitat for Humanity. The housing charity offers interest-free loans that require borrowers to pay only the principal. In Nashville, Habitat built Providence Park, a subdivision with 138 homes, more than a third of them occupied by Kurds. Kurdish immigrants Bayan Barwari, 34, and her husband, Deldar Muhammad, 35, pay just $385 a month for their house. "We fixed up the backyard. It's so big," says Barwari. "I feel like I'm in my country."

Not all Nashville residents have put out the welcome mat. Some locals had opposed the construction of Providence Park, predicting that the low-income home buyers would drag down home prices. But the immigrants have had the opposite effect: Overall property values in Providence Park have jumped significantly, boosting Nashville's tax coffers by $230,000 a year. Says Nashville Mayor Karl Dean: "The cities that are going to do well are cities that are attracting new people and reinventing themselves."

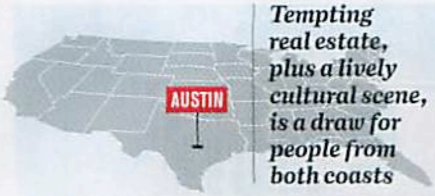
COMING TO AMERICA



*Rolling three-year average
Data: U.S. Dept. of Homeland Security

PHOTOGRAPH BY JOHN CHIASSON; CHART BY JOE RHAMES/BW

AUSTIN: THE PRICE MAGNET



Tempting real estate, plus a lively cultural scene, is a draw for people from both coasts

POPULATION
1,513,565

2007 MEDIAN HOME PRICE
$182,898

2008 MEDIAN HOME PRICE
$191,000

Numbers reflect metropolitan area
Data: Fiserv

The Hopkes (with Ryan and Connor) chose Texas over Silicon Valley

AFFORDABILITY'S ALLURE **Cost-conscious transplants from San Francisco, Los Angeles, and New York will move to affordable markets, including Austin, Tex., and Ann Arbor, Mich. The migration should help bolster home prices in those areas.**

Adelle Brewer, 43, and her husband, Daniel, decided they needed to leave Portland, Ore., last year. After their home insulation business faltered, the couple started researching less expensive cities in the Carolinas and Texas. In December they plunked down $149,000 in cash for a four-bedroom ranch house in an Austin suburb. "If this house were in Portland, it would be $400,000," says Adelle.

Although prices have dropped nationwide, affordability remains a key factor in the housing market. Transplants seeking a low cost of living and cultural amenities likely will gravitate to cities such as Austin, Minneapolis, and Ann Arbor. In the Texas state capital, the median home price of $191,000 is just under three times the median family income of roughly $69,100—a ratio that's in line with Ann Arbor and Minneapolis and below the national average. Ironically, the influx of new arrivals seeking cheaper housing will only drive up prices in those areas. Price increases, though, should be modest compared with the rest of the country since prices in those areas never saw the same lows. For example, Austin rose 4.4% in 2008 and is expected to fall off only modestly this year.

By Texas standards, Austin may seem pricey. But it's a bargain compared with cities such as San Francisco, New York, and Los Angeles. In Los Angeles, home prices are six times greater than the area's median income; they're seven times as much in New York and San Francisco. While the major urban areas on both coasts likely will remain expensive by comparison, the high-priced housing could keep a lid on values. In New York, the market isn't expected to turn around until 2012.

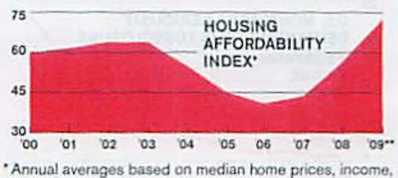
Why does Austin look so affordable? The city's economy lagged the U.S. for much of the boom as one big driver, the tech industry, struggled. First, the dot-com bubble imploded in 2000; Intel's chip design center stood half-built as a painful reminder of the tech bust until it was demolished in 2007. Then big local companies such as Dell and Freescale Semiconductor ran into trouble.

But Austin is on the upswing, with major employers, including the state government and health-care sectors, hiring. Job seekers are moving there in droves. Last year some 25,000 people relocated to Austin while cities such as Los Angeles and Chicago saw an exodus. Austin economist Angelos Angelou predicts that 38,000 more people will arrive over the next two years: "Even during a recession, people move to Austin."

The decision to relocate to Austin was an easy one for Kevin Hopke, 36, a technical writer for Sun Microsystems in Los Angeles. His boss gave him the option to move to Austin or Silicon Valley. After he found condos running at around $500,000 in Northern California, Hopke opted for Texas. In January, Hopke and his wife, Carmelita, 36, paid $176,000 for a 2,300-square-foot home in the suburb Round Rock. Now the Hopkes devote just 25% of their income to housing costs, vs. the 50% they would have paid in California.

BARGAINS FOR BUYERS

U.S. homes look more affordable



*Annual averages based on median home prices, income, and mortgage financing
**First quarter
Data: National Association of Home Builders/Wells Fargo Housing Opportunity Index

PHOTOGRAPH BY MATTHEW MAHON; CHART BY DAVID FOSTER

MERCED: GHOST TOWN, USA

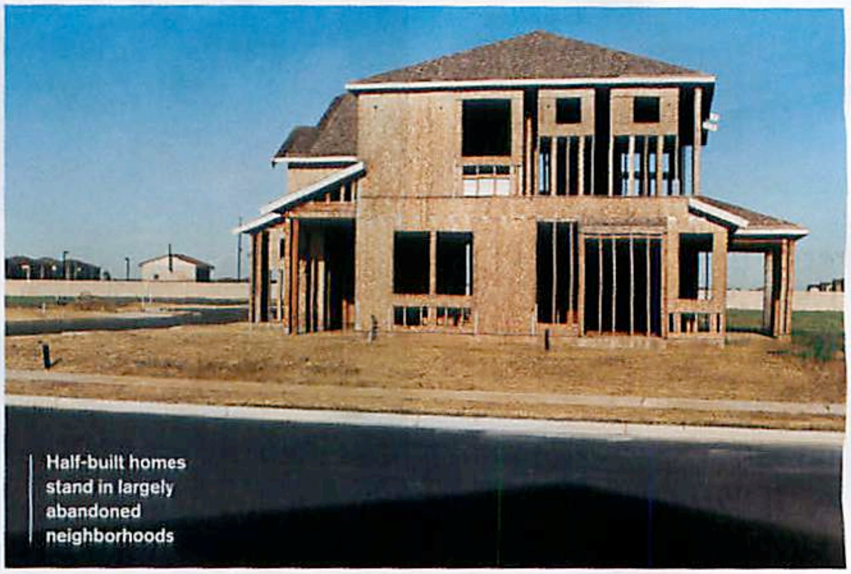
The housing crisis is hitting some cities harder than others. Merced, Calif., is a long way from recovery

POPULATION
245,658

2007 MEDIAN HOME PRICE
$230,440

2008 MEDIAN HOME PRICE
$144,000

All numbers refer to metro area
Data: Fiserv



Half-built homes stand in largely abandoned neighborhoods

FORECLOSURES Home prices have collapsed in cities such as Merced, Calif., and Port St. Lucie, Fla., where scores of borrowers can't keep up with their mortgage payments. Even when the rest of the country recovers, foreclosure-pocked areas still may be digging out.

The housing crisis is creating ghost towns of once-bustling communities like Merced. In largely abandoned neighborhoods, paved sidewalks and driveways lead to empty lots strewn with utility coils. Unfinished frames with rotting rafters and rusted hinges sit alongside occupied homes. Roughly 40% of the homes in Merced are considered distressed, meaning owners are behind on their mortgage payments or can't make them at all. The toll is expected to rise, even though California extended its moratorium on foreclosures for another 90 days.

Merced, situated in Central California's San Joaquin Valley, is an extreme example of what's happening across the country. As the economy tanks, foreclosures are soaring. Roughly one out of four subprime mortgages nationally is in trouble. Even so-called prime borrowers, who had good credit when they got their loans, now are having trouble keeping up; about 5% of these loans are in foreclosure, up from less than 1% in 2007, according to the Mortgage Bankers Assn. Rates are even higher in cities like Merced, Fort Myers, Fla., and Bakersfield, Calif., where the bust has been brutal.

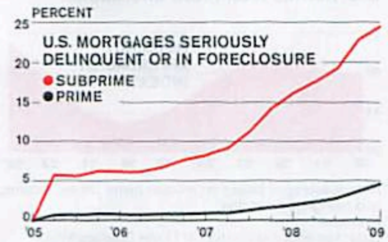
Such markets will continue to suffer as they work through the inventory of foreclosed properties. In Merced, property values have dropped 70% in some cases. With banks and borrowers dumping distressed homes, prices could fall by 30% more, according to Karen Weaver, a Deutsche Bank analyst. Merced, say analysts, will hit bottom by mid- to late 2010—after the rest of the country. In places like Bloomington, Ind., and Fayetteville, N.C., where homeowners are in better shape, the markets should be more resilient.

Foreclosure does present opportunities: Buyers and investors are scooping up distressed properties at cut-rate prices. Those purchases are helping jump-start sales in hard-hit states like California, Nevada, and Florida—the first signs of life in otherwise moribund markets. Jillian Mendoza, a high school teacher in Merced, bought her first home out of foreclosure in September. She paid $143,000 for the three-bedroom home, which the previous owner had bought for $325,000 several years ago. "I never thought I'd be able to buy a house at 25," says Mendoza. "I got such a deal on it that I'm not that worried about it losing value."

Like many former boom towns, Merced is paying the price for unsustainable growth. The University of California announced in 2001 that it would open its first new campus in more than 40 years on 84 acres in northern Merced. In anticipation of the potential demand, builders flocked to the area, and real estate investors bid up prices.

But they were overly optimistic. The school projected only modest admission rates and faculty hires—and housing supply far exceeded demand. Now the market lies in ruins, as unemployment tops 20%. Says Janet Young, assistant chancellor at UC Merced, which opened in 2005: "The housing boom was a huge surprise to us." | BW |

BAD LOANS



Data: Mortgage Bankers Assn.

PHOTOGRAPH BY GERRY GROPP; CHART BY DAVID RUDES/BW