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The Great Real Estate Revival

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HIGHLIGHT: As the housing bust draws to a close, how aggressively will home prices bounce back?

After its historic decline brought the global economy to its knees, the U.S. housing market is gearing up for a long-awaited recovery. Real estate experts expect home prices to hit bottom in late 2010 or early 2011 before--finally!--heading north again. But what shape will the rebound take? Are we in for another boom? Or will we have to settle for sluggish growth? Here's the outlook for home price appreciation through 2020:

The trajectory of real estate values will vary a great deal from one market to the next. But home prices at the national level should appreciate at "pre-bubble" rates once the market re-establishes its equilibrium, says Kenneth Rosen, chairman of the Fisher Center for Real Estate and Urban Economics at the University of California--Berkeley: "I'd say prices are back to [increasing] 1 or 2 percent more than the inflation rate over the next 10 years." Although that might seem like peanuts to those who watched prices skyrocket during the first half of the past decade, it's actually in line with long-term averages. When adjusted for inflation, American home prices increased by an average of about half a percentage point per year from 1890 through 2008, according to data compiled by Yale University Prof. Robert Shiller.

Modest increases in home prices will be supported by larger paychecks, says Mark Fleming, chief economist of First American CoreLogic. "In the long run, house prices basically go in lock step with wage growth," he says. With the unemployment rate holding in the double digits, that might not seem encouraging. But Fleming says that while the labor market is a late arrival in modern-day economic recoveries, jobs always return in some form. This time around, he expects high-tech companies and research-based industries like biotechnology to lead a resurgence that eventually sparks employment and wage growth throughout the economy. Inflation-adjusted personal incomes should increase roughly 2 percent a year from 2010 to 2020, according to Moody's Economy.com.

The "echo boomers." Meanwhile, demographic forces should boost demand for housing over the next decade, according to Harvard University researchers. Members of the "echo boom" generation--children of the baby boomers--are "entering their peak household formation years of 25 to 44 with more than 5 million more members than the baby boomers had in the 1970s," Harvard researchers said in a June 2009 report. "The echo boomers will help keep demand strong for the next 10 years and beyond." While some of this demand is likely to flow into the rental market, the preferred tax treatment of mortgage loans should help keep the American infatuation with homeownership alive. And if tax rates increase, as many expect, the value of the mortgage interest deduction will go up as well.

A more restricted flow of credit should prevent another housing bubble from forming anytime soon, says former Fed governor Lyle Gramley. Banks, hammered by souring loans, have raised their lending standards for even well-qualified borrowers. And federal regulators have taken steps to eliminate some of the reckless lending practices that precipitated the crash, such as banning lenders from making a higher-priced mortgage loan without first scrutinizing a borrower's ability to repay it. Tight mortgage credit "is going to persist for quite some time," Gramley says.

Still, housing bubbles haven't been driven to extinction. That's because the real estate market is cyclical. Regional housing markets have gone from boom to bust for as long as people have had mortgages. And because the booms generate so much wealth for homeowners, investors, and influential industries--like home builders--it's unlikely that Congress can work up the courage to snuff them out with tough regulation, says Mark Calabria, a former senior Senate staffer who now works at the**Cato Institute.** "It's not an economic question, it's a political question: How do you build institutions that push against bubbles when you know they are going to be incredibly popular when they happen?" Calabria says. "And we all know Congress does what's popular, not necessarily what's right." Nothing in Capitol Hill's effort to reform financial regulation suggests that things will be different this time, he says. Insufficient regulation is one reason he expects another real estate bubble to surface within 15 years. "I would bet my life on it," he says.

So what's the best way to play an asset that will appreciate 1 or 2 percentage points above inflation during periods of stability but can swing wildly in times of imbalance? Simple: Buy a house because you'd enjoy living in it, not because you expect blowout returns. Then you'll never be disappointed by its quarterly statements.