9 Housing-Market Head Winds for 2009

A look at the forces that will be working against a housing recovery in the new year

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With home prices having dropped a painful 21 percent from their 2006 peaks, property owners everywhere could use a splash of good news in their New Year's Eve cocktails. But as a nasty recession is now part of the picture, the chances of an aggressive housing market rebound next year are dim. "A lasting recovery in the housing market?" says Mike Larson, a real estate analyst at Weiss Research. "I don't see it in the cards until the back end of the year—if that."

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Here's a look at the factors that will be weighing down the housing market in 2009:

1. Recession After months of speculation, the National Bureau of Economic Research made it official Monday, announcing that the U.S. economy entered into a recession in December 2007. The only question now is: How painful a recession will we have? In a November 21 report, economists at Goldman Sachs revised their previous forecast to reflect a more significant economic contraction and higher unemployment. "We now estimate that real GDP is falling at a 5 percent annual rate in the current quarter, and we expect this to be followed by declines of 3 percent and 1 percent in the next two quarters," the economists said. "This deepens and extends the expected recession, bringing the drop in GDP close to the decline seen in 1982 (2.3 percent in our forecast versus 2.7 percent then)." The recession will exert downward pressure on the housing market in a number of ways.

2. Higher Unemployment The shrinking economy will result in additional layoffs, which will work to smother housing demand. The unemployment rate has already been climbing—it now stands at 6.5 percent—but many expect it to increase significantly in the coming year. Goldman Sachs projects the unemployment rate to hit 9 percent by the end of 2009. "This forecast, if correct, makes the current recession unequivocally the worst single downturn on record since World War II insofar as increases in joblessness are concerned," the economists said. Fewer jobs mean fewer home buyers, since an income stream is essential to obtaining a mortgage. "A job is necessary for a home," says Mark Zandi, chief economist at Moody's Economy.com. "Without [a job] you can't get [a home]."

3. Consumer Confidence If consumers are worried about the state of the economy and their jobs, they are much less likely to make the biggest financial investment of their lives: buying a house. With a leading survey showing that consumer confidence in the United States dropped to 28-year lows in November, downward pressure on this front will be working against the housing market as well. "You generally don't buy a home unless you feel pretty good about your economic situation," Zandi says. "No one feels good [today]."

4. The Underwater Effect A recent Zillow report found that 1 in 7 American homeowners has negative equity—owing more on a home than it is worth. (For those who bought a home in the past five years, it's nearly 1 in 3.) Many homeowners in this situation will choose to simply walk away from their homes rather than continue to pay off a devaluing investment. And with home prices expected to fall further next year, the number of "underwater" mortgages will most likely increase. "The underwater phenomenon is going to be very bad in 2009," says Christopher Thornberg of Beacon Economics.

5. Tighter Credit As banks face higher loan delinquencies, they've responded by jacking up their lending standards for even well-qualified borrowers. The Federal Reserve's most recent Senior Loan Officer Survey found that 70 percent of domestic banks had boosted their lending standards for prime mortgages. More stringent terms will prevent certain borrowers from obtaining mortgages, thereby limiting demand for housing.

6. Slowing Household Formation At the same time, the pace of new household formation is slowing, which further chips away at housing demand. Richard Moody, chief economist at Mission Residential, says the development is linked to three factors: More singles are moving in with each other, young adults are returning to live with their parents, and fewer immigrants are entering the country. "For those three reasons, you are seeing a slowdown in the rate of household formation," Moody says. "And to the extent that the economy and the labor market remain weak this year—which I think they will—then that's going to continue."

7. Radioactive Effect Despite lower real estate prices and cheaper mortgage rates, the pain inflicted by the housing bust will frighten many would-be buyers away from the market next year, Larson says. "Enough of your 'average Joes' have been burned very badly and will be burned by the time this is all over that investment money is not going to flood back into the market," Larson says. "Any recovery—in my opinion—will be gradual and is going to take time."

8. Foreclosure Sales A huge problem for the housing market in 2008, foreclosure sales will continue weighing down the market next year. "There was a surge this year," Zandi says. "But next year [there] will be even more." While that will give buyers an opportunity to go bargain hunting, it's bad news for sellers. "It puts more homes out there for sale at a very deep discount," Zandi adds.

9. Subprime Mortgages While resetting subprime mortgages may not be a leading factor behind the decline in home prices—as they were this year—such products will again be working against the housing market in 2009, Thornberg says. "There are still lots of subprime mortgages out there that are going to reset not just in 2009, but 2010 and 2011," he says. "And so that's going to be a consistent problem for a while, although it is probably reduced in magnitude [from 2008]."

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