The 2009 Economic Landscape

The Sand States: Anatomy of a Perfect Housing-Market Storm

The historic boom and subsequent decline in the nation's housing market has been a defining feature of the current recession. The housing downturn has been most acute in four states—**Arizona**, **California**, **Florida**, and **Nevada**—that had experienced some of the highest rates of home price appreciation in the first half of the decade. While these states are not all contiguously located, their similar housing cycles and abundance of either beaches or deserts have led some analysts to label them "Sand States." This article discusses the factors that led to an expanding housing sector in these states and the market imbalances that culminated in a sharp correction in home prices. The article also explores the ripple effects that the housing downturn has had on the local economies.

Rapid Population Growth in the Sand States Propelled Housing Markets

For many years, rapid population growth in the Sand States spurred higher than average rates of home construction. Favorable weather and relatively affordable housing are two factors that attracted retirees as well as younger families to these states. In the 1980s and 1990s, population growth rates in Arizona, Florida, and Nevada were between two and four times the national rate. Certain parts of California, such as the **Riverside–San Bernardino** metropolitan area, experienced similarly high rates of population growth. Rapid population growth continued into the early years of this decade. From 2004 to 2007, Arizona and Nevada ranked as the two fastest growing states in the nation, followed closely by Florida, which ranked ninth.[1]

The influx of new residents into Arizona, Florida, and Nevada also contributed to strong employment growth. Job creation in these states frequently outpaced the rest of the nation during the past few decades. From 2000 to 2006, these states repeatedly ranked among the top ten for job growth, far exceeding the national average. California generally reported job growth similar to the national average during this period, although the state was hit hard by the dot-com recession from mid-2001 to 2003.

[1] U.S. Census Bureau.

Affordability Mortgages Contributed to Housing Imbalances

During this decade, strong demand for housing, supported by a growing population and an expanding economy, contributed to growing housing market imbalances across the Sand States. Perhaps the best measure of the imbalances that accumulated in booming housing markets during this decade was the relationship between home prices and incomes. In the years leading up to the housing downturn, escalating home prices far outpaced income growth. For example, in 2003, housing in Nevada was considered relatively affordable, both in absolute terms and as compared to other states. According to one analysis, a family earning the median income in Nevada in 2003 could afford a home that was priced approximately 20 percent above the median house price in the state using traditional mortgage financing.[2] However, by late 2005, home prices had risen so much that a family earning the median income could only afford a home priced at 24 percent *below* the state's median price.

A combination of factors drove the housing sector imbalances in the Sand States to unprecedented levels. Under normal market conditions, strained affordability tends to limit housing demand because fewer households can purchase a home using traditional mortgage financing. However, in this cycle, new mortgage "affordability" products were commonly used to finance home purchases. Besides traditional adjustable-rate mortgages (ARMs), affordability products included *hybrid ARMs*, which have a low, fixed interest rate for several years followed by a market rate that is frequently much higher. Affordability products also comprised the so-called nontraditional mortgage products, which included *interest-only loans*, where amortization of principal was not required during the first few years of the

[2] Moody's Economy.com Affordability Index. The calculation assumes a 30-year maturity and a down payment of 20 percent. It also assumes that the monthly principal and interest payments do not exceed 25 percent of the median family income. To interpret the indices, a value of 100 means that the family earning the median income can afford only 100 percent of the traditional mortgage payment of the median-priced home, taking into consideration the 20 percent down payment.

loan; *negative-amortization loans* that offered initial payments well below the amount required to cover interest and amortize principal; and *balloon payment loans*, which typically required a large lump-sum payment at the end of the loan. Unlike *subprime* mortgage products that were designed for home buyers with limited or weaker credit histories, these nontraditional mortgages were marketed broadly and often used by first-time home buyers and investors who did not provide a down payment. In addition, originators of these products frequently did not require buyers to verify that their income could support the mortgage payments.

By 2006, nearly half of total U.S. originations of privately securitized affordability mortgages were made in the four Sand States alone. Moreover, the proportion of these mortgages originated in these states, including nontraditional mortgages, rose as home prices escalated. During 2002, these products accounted for roughly half of the privately securitized mortgage originations in each of the Sand States, comparable to the rest of the nation. By 2006, however, the proportion of these products had increased to 80 percent of privately securitized mortgage originations. Nationwide, the percentage was about 70 percent.[3]

The increased presence of speculators or investors in the Sand States also contributed to growing imbalances in the housing sector. Data from mortgage servicers indicate that nonowner, investor, and second-home mortgage originations increased noticeably in Arizona, Florida, and Nevada between 2000 and 2005.[4] Investor and second-home purchases tended to be more heavily concentrated in major metropolitan areas in these states, such as **Las Vegas**, **West Palm Beach**, **Miami**, and **Phoenix**.

Strong housing demand coupled with escalating home prices served as a dual incentive for builders to increase the supply of homes, arguably at a rate that exceeded short-term demand. New home construction started to accelerate in 2002, and, over the next three years, housing starts in these four states increased an average of 11 percent annually, or about twice the rate of increase elsewhere in the nation. Housing construction in the Sand States far outpaced annual growth in the number of households, which peaked at 1.6 percent in 2004 and 2005.

Labor market imbalances also arose as job growth became skewed toward the housing sector. During the height of the boom, construction employment grew 10 percent per year in these states, far outpacing growth in other industry sectors. During this time, construction jobs accounted for a disproportionate 25 percent share of new jobs, while representing less than 10 percent of total employment.

Tipping Point: Imbalances Lead to Housing Collapse

Ultimately, the housing boom in the Sand States proved to be mostly a mirage. The first signs of trouble came in the form of sharply decelerating rates of home price appreciation. Between 2003 and 2006, annual home price appreciation rates in these states had consistently exceeded the national average. Year-over-year house price appreciation in Nevada peaked in 2004 at 37 percent. In Arizona and Florida, appreciation peaked in 2005 at rates more than twice the national average. Since then, average home prices in the four states have declined between 27 and 38 percent from their peak.[5] Price declines have been most severe in metropolitan markets such as Phoenix and Las Vegas, which registered the largest percentage declines in the nation at 34 percent and 33 percent, respectively, during 2008.[6]

As home prices slumped, foreclosure activity rose at a startling pace. While this phenomenon was occurring across the nation, it was most pronounced in the Sand States. According to the ***Mortgage Bankers Association***, the Sand States accounted for more than 40 percent of all mortgage foreclosures started in 2008, which is nearly double the share of mortgages held by borrowers in these four states (see Table 1). This disproportionate share of troubled mortgages in the Sand States was most acute among ARMs. In 2008, these states held 46 percent of the prime ARMs outstanding nationwide and 64 percent of foreclosures started within this mortgage category.

In fourth quarter 2008, foreclosure resales accounted for more than 55 percent of all California resale activity, almost three times the level of a year ago. Foreclosure resales were also prevalent in Las Vegas and Phoenix, where this type of transaction accounted for about 71 and 65 percent, respectively, of house and condominium resales.[7]

[3] Data are from Loan Performance. Affordability mortgage products include ARM loans, interest-only loans, negative amortization mortgages, balloon loans, and hybrid ARMs. Affordability originations are measured as a percentage of privately securitized origination, first liens only.
[4] In contrast, California had less investor activity during the period, likely because the median home price in the state was relatively high, resulting in a less attractive rate of return for potential investors.
[5] Federal Housing Finance Agency, purchase-only index data through fourth quarter 2008.
[6] S&P/Case-Shiller Home Price Index, data as of December 2008.
[7] Data Quick Information Systems through www.dqnews.com. Las Vegas and Phoenix data are for February 2009.

Table 1

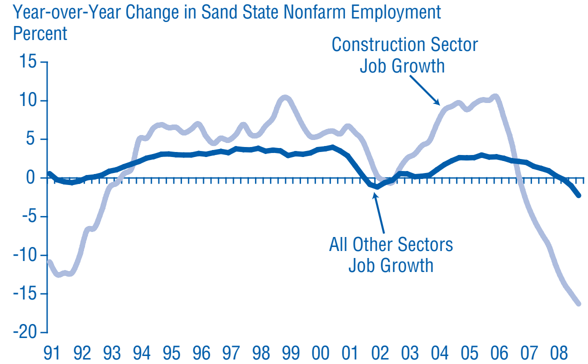
The Sand States Account for a Disproportionately High Share of Foreclosure Activity	National Share of Foreclosures Started	National Share of Mortgages Serviced
California	19.2%	12.9%
Florida	16.2%	7.8%
Arizona	4.4%	2.7%
Nevada	2.7%	1.2%
Sand States Total:	**42.5%**	**24.6%**

Source: Mortgage Bankers Association.

Note: Data from first quarter 2008 through fourth quarter 2008. "Sand States" is the aggregate of California, Florida, Arizona, and Nevada.

Chart 1

The Construction Sector in the Sand States Has Been an Important Driver of Job Growth



Source: Bureau of Labor Statistics (Haver Analytics).

Note: "Sand States" is the aggregate of California, Florida, Arizona, and Nevada. "All Other Sectors" is the state aggregate nonfarm employment minus the construction sector.

Economic Conditions Remain Fragile as the Effects of the Housing Collapse Spread

Compounding the housing-sector problems in the Sand States, and elsewhere, has been the virtual shutdown of private mortgage-backed securities (MBS) issuance since 2007. MBS issuance had largely financed the subprime and nontraditional lending that fueled the boom. Total issuance of private MBS, which had topped $1 trillion annually in both 2005 and 2006, fell precipitously thereafter, totaling just over $50 billion in 2008. Meanwhile, the difficulties that market participants have had in valuing complex mortgage securities and the derivatives based on them have contributed to wider risk aversion in financial markets, which has reached historic proportions. For housing markets, particularly in the credit-fueled boom markets of these four states, these financial market disruptions are compounding what would in any case have been a steep and extended housing market downturn.

The housing market downturn in the Sand States is now having serious ripple effects on other parts of the local economy. Each of the Sand States lost jobs in 2008. The losses have been most pronounced in the construction sector, which has shed more than 450,000 jobs, or about 24 percent, between fourth quarter 2006 and fourth quarter 2008 (see Chart 1). In addition, job losses have spread to the financial services and retail trade sectors. Retail sales also have declined, particularly for home improvement, furniture, and electronics store sales, contributing to additional layoffs.

Although the Sand States entered this downturn with relatively low rates of unemployment, joblessness increased during 2008 to levels not seen since the 2001 recession. The unemployment rates for California, Florida, and Nevada ranked among the top ten in the nation as of fourth quarter 2008. While Arizona's unemployment rate remained slightly below the national average as of fourth quarter 2008, it too rose markedly during the year. These rising unemployment rates are due primarily to widespread job losses and, to a lesser degree, to additional people entering the labor force in search of employment, including college graduates and retirees.[8] Also, rising unemployment claims are putting more pressure on already strained state budgets.

Nonetheless, a few positive, albeit very preliminary, signs may be emerging. The volume of home sales in Arizona, California, and Nevada improved during 2008 relative to year-ago levels. The increase in foreclosures sales is likely contributing to some renewal in sales activity. In addition, while a sharp decline in housing starts is eliminating construction jobs in the near term, it should eventually facilitate the return to a more stable housing landscape. Seasonally adjusted housing starts in the Sand States dropped 40 percent in 2007 and again in 2008. Also, despite the weakened housing and labor markets, population growth in Arizona, California, and Nevada was estimated to be above the national rate in 2008.[9] This continued growth will be an important source of long-term housing demand that will eventually help bring a measure of stability to these troubled housing markets.

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[8] California Employment Development Department.

[9] U.S. Census estimates of state-level population growth between July 1, 2007, and July 1, 2008, the latest data available.