With McMansion bubble going bust, is recession far behind?

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Bubble, bubble, Toll's in trouble. This week, Toll Brothers, the nation's premier builder of McMansions, announced that sales were way off, profits were down, and the company was walking away from already-purchased options on land for future development.

Toll's announcement was one of many indications that the long-feared housing bust has arrived. Home sales are down sharply; home prices, which rose 57 percent over the past five years (and much more than that along the coasts), are now falling in much of the country. The inventory of unsold existing homes is at a 13-year high; builders' confidence is at a 15-year low.

A year ago, Robert Toll, who runs Toll Brothers, was euphoric about the housing boom, declaring: "We've got the supply, and the market has got the demand. So it's a match made in heaven." In a *New York Times* profile of his company published last October, he dismissed worries about a possible bust. "Why can't real estate just have a boom like every other industry?" he asked. "Why do we have to have a bubble and then a pop?"

The current downturn, Toll now says, is unlike anything he's seen: Sales are slumping despite the absence of any "macroeconomic nasty condition" taking housing down along with the rest of the economy. He suggests that unease about the direction of the country and the war in Iraq is undermining confidence. All I have to say is: pop!

Now what? Until recently most business economists were predicting a "soft landing" for housing. Even now, the majority opinion seems to be that we're looking at a cooling market, not a bust. But this complacency looks increasingly like denial, as hard data – which tend, for technical reasons, to lag what's actually going on in the market – start to confirm anecdotal evidence that it is, indeed, a bust.

Why the sudden crackup? When prices were rising rapidly, some people bought houses purely as investments, betting that prices would keep going up. Other people rushed to buy houses, or stretched themselves to buy houses they couldn't really afford, because they feared that prices would rise out of reach if they waited. And all this speculative demand pushed prices even higher. In other words, there was a market bubble.

But eventually prices reached a level beyond what even optimistic potential buyers were willing to pay, especially after interest rates rose a bit. (They're still low by historical standards.) As demand fell short of supply, double-digit price increases declined into the low single digits, then went negative everywhere except in the South.

And with prices falling in many areas, the speculative demand for houses has gone into reverse, as people try to get out with a profit while they still can. There's now a rapidly growing glut of unsold houses. This is a recipe for a major bust, not a soft landing.

Moreover, it could be both a deep and a prolonged bust. Since 2000, much of the nation has experienced a rise in home prices comparable to the boom in Southern California during the late 1980s. After that bubble popped, Los Angeles house prices began a slow, grinding deflation, eventually falling 20 percent (34 percent after adjusting for inflation). Prices didn't begin a sustained recovery until 1996, more than six years after the downturn began.

Now imagine the same thing happening across a large part of the United States. It's an ugly picture, and not just for people and companies in the construction business. Many homeowners – especially those who bought their houses with interest-only loans or with minimal down payments – will find themselves in financial distress. And the economy as a whole will take a hit.

As far as I know, Nouriel Roubini of Roubini Global Economics is the only well-known economist flatly predicting a housing-led recession in the coming year. Most forecasters consider his call alarmist, and many Federal Reserve officials remain optimistic. Last week, Richard Fisher, the president of the Federal Reserve Bank of Dallas, dismissed "Eeyores in the analytical community" who worry about a possible recession.

Call me Eeyore. While I don't share Roubini's certainty, I see his point: Housing has been the main engine of U.S. economic growth over the past three years, and with that engine now going into reverse, it's hard to see how we can avoid a serious slowdown.