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Oil Prices Raise Cost Of Homeownership, Threatening Housing Recovery

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By William Alden

NEW YORK -- As unrest in the Middle East shows little sign of cooling, the price of a barrel of oil continues to climb, raising transportation and heating costs in turn. Already, Americans have cut back on spending, and small businesses have scrapped plans to hire new workers.

And the pain could get worse as rising energy costs begin to threaten a sector that's already taken a historic beating in recent years: the housing market.

The prospect of a much more expensive commute is beginning to make suburbia look less appealing. As demand for such homes weakens, economists worry that growth in the real estate market -- and the broader economic recovery -- could be stopped in its tracks.

"It really blunts the hope of rebound in a lot of those outlying areas," said Joe Cortright, president and principal economist of the consulting group Impresa, in Portland, Ore. "Those housing units come with the added penalty of a higher commuting price."

Rising energy prices hike several key components of the total cost of living for many Americans. Not only does driving become more costly, heating and cooling also become less affordable. In the winter, high heating bills can encourage consumers to go without, causing pipes to freeze. As summer nears, the prospect of air-conditioning a spacious suburban home increasingly seems untenable. Homeownership, predicated to a significant degree on affordable energy prices, is becoming more expensive.

"Once you start to see gas prices get into the $4 range, that's going to have a downward effect on sales," **said Bernard Baumohl**, chief global economist at the Economic Outlook Group, who until recently was known for his relatively optimistic predictions. "Home sales deteriorate probably exponentially after that."

The oil price spike could hardly come at a worse time for the ailing housing market, which, along with high unemployment, continues to weigh heavily on the U.S. economy.

While financial and manufacturing sectors have recently shown strong signs of recovery, housing seems to get worse.

Since peaking in 2006, home prices have fallen 31 percent, according to the Case-Shiller 20-city index. Last year, nearly 2.9 million homes received foreclosure notices, an increase of 2 percent from 2009, according to data collected by RealtyTrac, an online foreclosure market. More than a quarter of all U.S. home sales last year were of foreclosed properties.

This situation isn't helped by a lack of demand. For homeowners, the price fall can be a vicious cycle: Falling home values erode homeowners' wealth, making them more vulnerable to default and foreclosure, which in turn tends to drive nearby home values even lower. As potential buyers see prices fall, they become less interested in making a long-term investment in a home. Until prices hit bottom and a home turns from a sinkhole into a bargain, buyers are expected to show the kind of tentativeness that aggravates a slump.

Oil could make things even worse. Gas prices have lately been climbing toward $4, making consumers less and less able to spend money on other things as their dollars head from the U.S. economy to oil companies overseas.

"The big increase in oil prices serves as an effective tax on consumers, which means they'll have less capital to spend on housing expenditures," said Michelle Meyer, an economist at Bank of America Merrill Lynch. "People are going to be looking for an even lower price."

To some extent, of course, the decision to purchase a home is insulated from rising gas prices. Because a house is a long-term investment, homebuyers consider what their income will be over the next several decades, not just over the next few months, and may dismiss the gas hike as a temporary inconvenience.

"People would have to perceive that energy prices would be stuck at this high of a level for the foreseeable future," Meyer said. "At this point I don't think people are convinced of that, nor should they."

But as long as unrest in the Middle East has dragged on, the price of oil has continued an uneven but persistent rise, with investors afraid the world's supply could be significantly disrupted. Professional investors and average commuters who are closely watching energy prices have seen unexpected events unfold daily. The key takeaway, experts say, is that events that seem improbable can nevertheless happen.

As protests began in Tunisia and spread to Egypt, then to Bahrain, Libya and elsewhere, the market has evidently priced in the possibility that the oil-producing heart of the region, Saudi Arabia, could see its output compromised.

"Unfortunately it's sort of a known unknown," said Michael Darda, chief economist of MKM Partners, an institutional equity research, sales and trading firm. "We know this is going on. No one knows really where it stops."

While investors' fears have been driving oil prices higher, consumers' fears could effectively keep home prices pinned down.

Every few days, headlines announce that the price of oil has reached a new record, achieving highs not seen since 2008, when months of astronomical energy prices were dragging the economy into recession. The price of a barrel of Brent crude, an industry benchmark, cleared $118 on Monday, after starting the year at around $95. Each $10 rise in the price of a barrel of oil translates into a 25-cent increase in gas prices, which tears more than $25 billion from the economy yearly, economists say.

"Chronically-high energy prices obviously are not a friendly development for housing," **Baumohl** of the Economic Outlook Group said. "If households are squeezed, you can expect the demand for homes will likely weaken. With that, of course, we could expect to see perhaps even more foreclosures."

Already, Americans have cut back. Although surveys in recent months have shown an improvement in so-called consumer confidence, high prices at the pump seem to be hurting that newfound enthusiasm. One in three U.S. consumers has already significantly reduced discretionary spending, according to a new survey from RBC Capital Markets. Small business owners say that higher transportation costs will force them to charge customers extra fees and put hiring plans on hold.

With transportation more expensive, prospective homebuyers become less willing to buy in a community miles from a city. When demand for far-flung houses weakens, prices stay depressed and the broader housing recovery can be threatened.

"It's really more of a reminder that there's a lot of volatility in [energy] prices," Cortright, the consulting firm president, said. "People think, 'Do I really want to expose myself to the risk? I may have to pay even higher prices in the future.'"

In the suburban community of Homestead, Fla., where the mortgage delinquency rate is statistically the worst in the nation, homeowners are now suffering from the added strain of expensive gas, the *Wall Street Journal* reported last week.

Some potential homebuyers might choose to refrain from house-hunting altogether, as even the long hours of driving involved in searching for a new place to live could seem like an undue cost. Already, consumers have begun to cut back on driving.

But some experts were skeptical that expensive gas would have much impact on what's already a persistently weak market. Diane Thompson, a lawyer at the National Consumer Law Center, who has spent nearly two decades representing homeowners, said the problems in the housing market run deep.

"The scale of the housing crisis swamps all of things you might expect to contribute to it," Thompson said. "We had this explosion of predatory non-affordable loans for a decade leading up to this, and those loans are still working their way through the system."