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# BETTING THE HOUSE

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Beginning in 2002 and with increasing frequency this year, we have been asked by our clients for our opinion with regards to residential real estate investment opportunities, both local and otherwise. Consequently, we decided it was time to write this letter to our clients.

Increasingly, economists have been warning that the U.S. housing market has entered bubble territory. There is significant evidence that many parts of the U.S. housing market are overvalued. We thought it would be useful to discuss some of the factors that have fostered the appreciation in housing prices, since the reversal of these inputs could cause housing price declines, perhaps significant price declines, in certain over-heated markets.

To an extent, the current housing bubble was facilitated by the Internet bubble. Some investors, hurting from losses in their equity portfolios, moved money from one asset class to another in search of "safety." To a greater extent, the current housing bubble can be attributed to low mortgage rates. In order to stimulate the economy out of the recession that followed the collapse of the equity markets, the Federal Reserve began lowering the Fed Funds rate from 6.5% in mid-2000 to a four-decade low of 1.0% by mid-2003. Mortgage rates, both short and long term, declined in a similar fashion over the same period.

Additionally, innovations in mortgage finance, such as interest-only mortgages, negative amortization mortgages and adjustable-rate mortgages (ARMs), in conjunction with lax mortgage underwriting standards, provided additional stimuli. A recent housing article in the *Economist* provided several disturbing statistics published by the National Association of Realtors (NAR). According to NAR, 42% of all first-time buyers and 25% of all buyers made no down-payment on their home purchase in 2004. In addition, interest-only and negative amortization mortgages have become increasingly prevalent. For example, in California, over 60% of all new mortgages in the first quarter of 2005 were interest-only or negative-amortization mortgages, up from 8% in 2002. These new loans are essentially a bet that prices will continue to rise, allowing the borrower to sell the home at a profit or refinance before any principal has to be repaid.

Meanwhile, ARMs have risen to 50% of all mortgages in those states with the biggest price acceleration. Whereas a traditional 30-year fixed mortgage guarantees an interest rate for the entire life of the mortgage, an ARM locks in a lower interest rate for a shorter duration of time (typically for one, three, five, or seven years), and subsequently adjusts to the prevailing mortgage interest rate at the time, which could be considerably higher.

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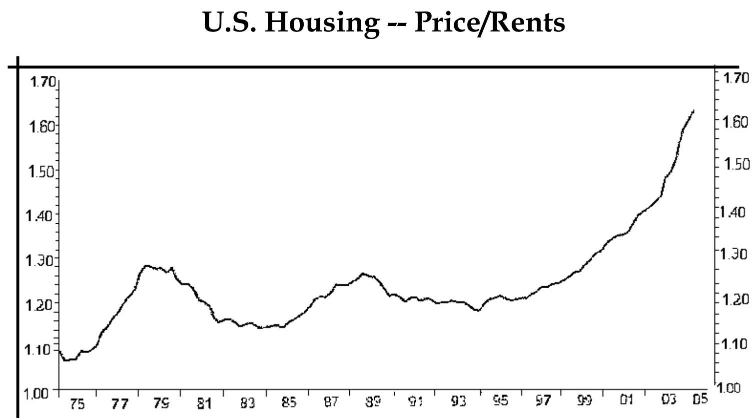
There is plenty of evidence supporting a U.S. residential real estate bubble. Consider the following excerpt from *The Economist*:

> *A study by NAR found that 23% of American houses bought in 2004 were for investment, not owner-occupation. Another 13% were bought as second homes. Investors are prepared to buy houses they will rent out at a loss, just because they think prices will keep rising – the very definition of a financial bubble. "Flippers" buy and sell new properties even before they are built in the hope of a large gain…Many properties change hands two or three times before somebody finally moves in.*

Note, however, that the NAR study also indicated that this national statistic (the 36% of 2004 home purchases that consisted of investment properties and vacation homes) is skewed geographically towards coastal cities, mountain cities and vacation spots.

The most compelling evidence that home prices are over-valued is the divergence between home prices and rents as shown in the following chart:

**U.S. Housing -- Price/Rents**




*Source: Dresdner Kleinwort Wasserstein Macro Research*

The price/rents ratio can be used as a proxy for housing valuations, much like how equity investors use the price/earnings ratio to value stocks. According to *The Economist*, the U.S. ratio of prices to rents is 35% above its average level during 1975-2000. Again, certain markets are far more skewed. To bring the ratio back into equilibrium, either rents must rise sharply or home prices must fall.[1]

Finally, home prices are growing faster than per-capita personal income in many markets. According to the Federal Deposit Insurance Corp., nationwide home prices rose 6.7% faster than incomes for the 12-month period ended March 31, 2005. Again, this gap is widest in four large vacation markets: Nevada (24.8%); California (19.6%); Hawaii (18.7%); and Florida (15.4%).[2]

Housing prices may indeed decline significantly in certain markets where there is an unusually high level of speculative investment. However, it is unlikely that a decline in one or two or

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[1] "*In Come the Waves*," The Economist. June 16, 2005. p. 4.
[2] Simon, Ruth. "*Housing Gets Even Less Affordable*," The Wall Street Journal. July 14, 2005. p. D1-2.

even several highly speculative markets would trigger a national decline. Unlike equity markets, housing is generally local, and prices are set by local supply and local demand considerations.

In our opinion, only a dramatic rise in long-term interest rates would seriously impact national housing prices. Given that inflation remains low and in-check, we do not anticipate a dramatic rise in long-term rates. Furthermore, we believe housing speculation will likely be curbed by the continued rise in short-term interest rates as short-term mortgage structures (e.g., ARMs and negative amortization loans) become relatively less attractive to prospective buyers.

We mentioned previously that the price/rents ratio of the housing market is currently 35% above the 1975-2000 historical average. While housing prices could decline in order to bring the ratio back into alignment, rents could also rise. Either way, in our opinion, residential real estate investors should expect to see several years of little or no appreciation in the value of their properties. Rents, however, may firm up, reflecting their superior value relative to ownership.

Finally, the housing market is buffered by the fact that, in most cases, an owner can choose to live in his or her house rather than sell the house at a low price. Only owners who can not afford their mortgage payments would be forced to sell, perhaps at a significant discount to their purchase prices. Given that the U.S. economy is healthy and unemployment is low, we expect most owners to be able to meet their payment obligations.

Nationally, the housing boom shows few signs of abating. In the first quarter of 2005, in 25 of the top 100 metropolitan markets, the rate of home price appreciation was at least 20%.[3] However, a recent *Wall Street Journal* article indicated that the Chicago condo market is softening due to high prices and oversupply. Chicago ranks third in the nation in terms of condos that are expected to be completed this year (new buildings and rental conversions). Several large projects are not selling at anticipated rates and at anticipated prices, thereby forcing developers to approach their bankers for loan extensions or additional financing.

In closing, the message we wish to communicate to you is simply this – speculating in residential real estate at this time may be hazardous to your financial health. For those wishing to purchase second homes, particularly in over-heated markets, consideration should be given to renting.

[3] Roach, Stephen S. "*From Bubble to Bubble*," Morgan Stanley Equity Research. June 24, 2005. p. 2.