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The 29th bubble

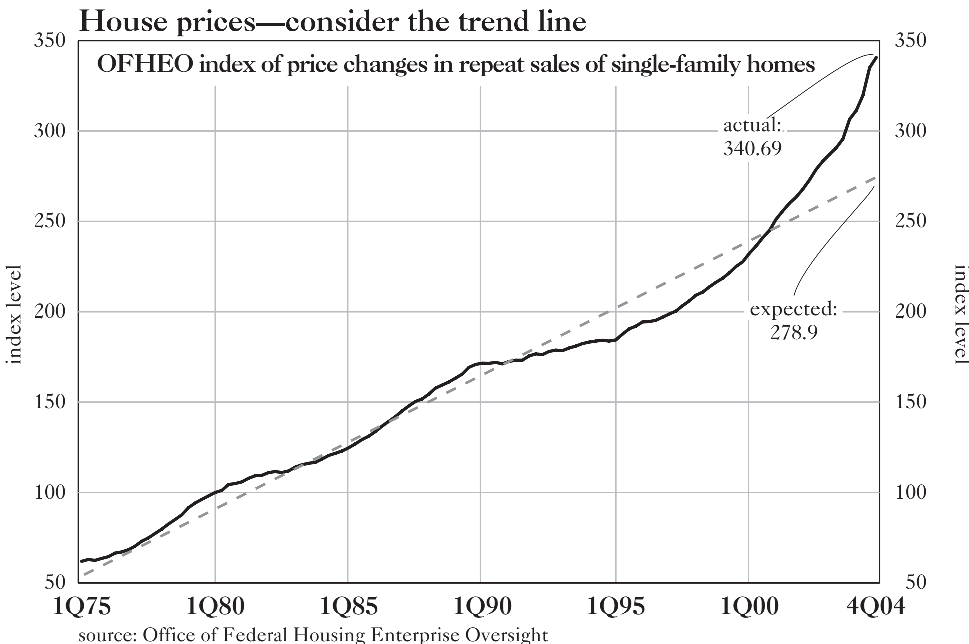
"We don't perceive that there is a national bubble," Alan Greenspan, speaking about house prices, advised the Economic Club of New York the other day, "but it's hard not to see . . . that there are a lot of local bubbles." For what might be the first time in his life, the Maestro thereby staked out a genuinely contrary investment position. These days, bearishness on house prices has become an Approved Institutional Opinion, much like bullishness on almost everything else.

Following is a new contribution to the negative literature. We do not mean to be repetitive, or—worse yet—banal, and we believe we are not. One proof we offer is the title of an essay by the real-estate authority we are about to quote. It is: "Growth of Dolphins, *Coryphaena Hippurus and C. Equiselis*, in Hawaiian Waters as Determined by Daily Increments on Otoliths" (Fishery Bulletin, U.S. Department of Commerce, Vol. 84, 1986). Which other expert on U.S. house prices could make an even remotely similar claim? The author's view, and ours, is that, in residential real estate from Miami to Seattle, "bubble" is the word.

It's not a word just to toss around. A bubble market is one that goes way, way up, then comes way, way down. And house prices have gone way, way up—in April, the median existing home price showed a year-over-year gain of 15%. But they have not come way, way down. Indeed, the national average has not registered a broad-based decline in living memory. Since the 1930s, sideways is as bad as a bear market in American residential real estate has gotten (though there have been some ferocious localized declines). "[H]istory is definitive," pronounced the *American Banker* in a May 23 article on interest-only mortgages, "The national average price of a home may remain relatively flat for a number of years, but it doesn't fall." Let's see about that.

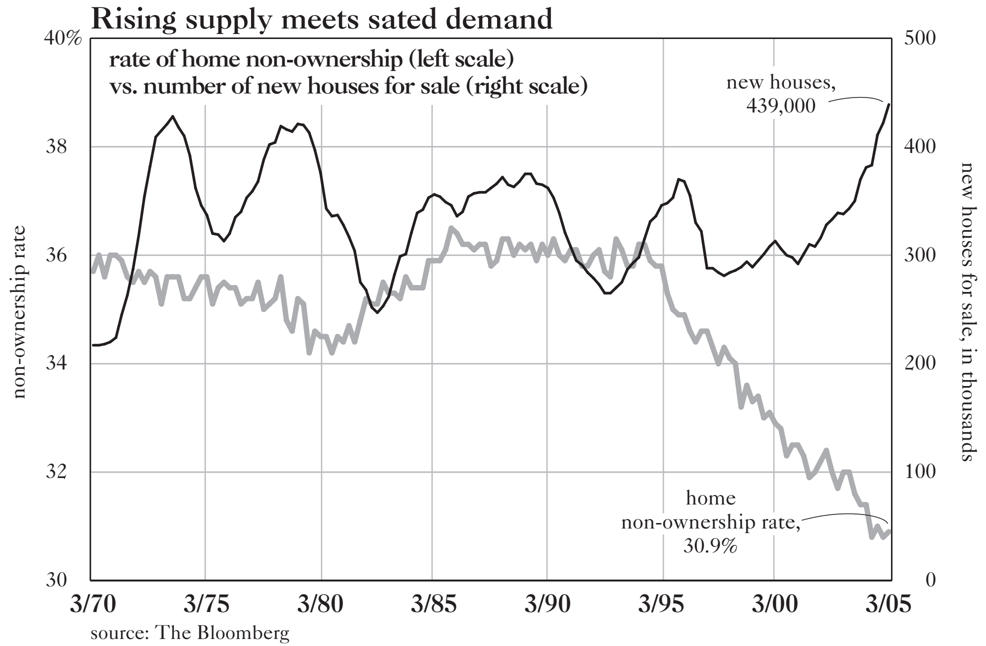
If the 2005 U.S. residential real estate market were in a bubble, and if prices did not subsequently fall, that would constitute a first. A bubble is a defined phenomenon; not just any frothy market makes the grade. According to the analysts at GMO, Boston, a bubble is a two standard deviation event, and they have identified only 28 of them since the Coolidge bull stock market.

Physicists rightfully smile at the pretensions of Wall Street's quants. But, in the matter of bubbles, the financial analysts may have discovered an actual law of nature. In 27 of the 28 cases, according to GMO, sky-high prices eventually returned to earth, frequently making a small crater as they landed. The one known outlier is the 28th and current bubble, the S&P 500, which would have to fall to about 750 to revert to the mean (it closed Tuesday at 1,192). "Have to fall," in fact, is not quite accurate. By trading sideways for a decade or so, the S&P might revert to trend with a whimper, not a bang. So, the question that should absorb us all: Are U.S. house prices in that kind of a market?



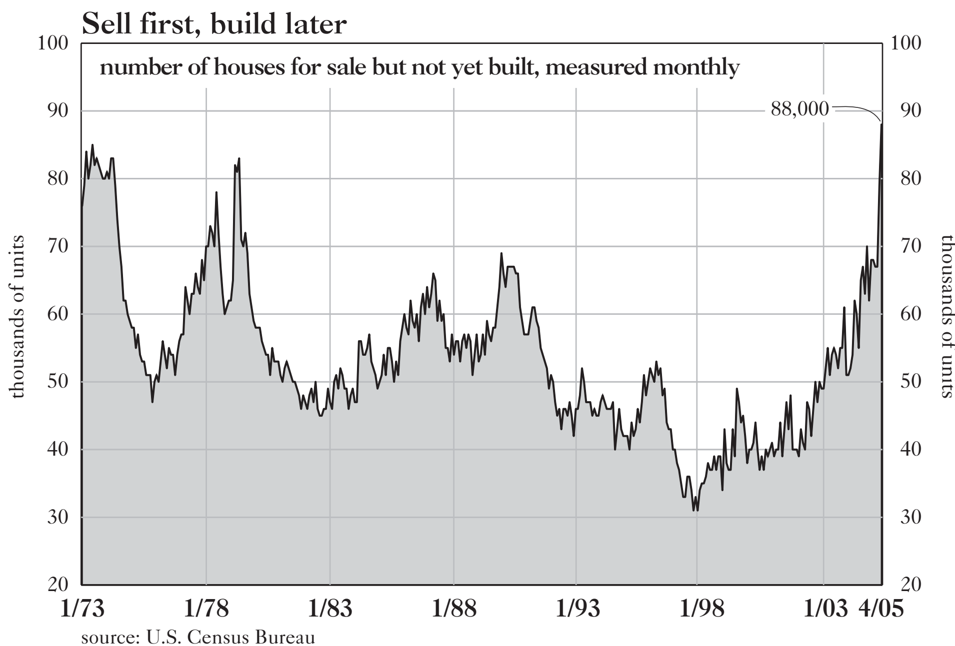
We base our affirmative reply on many things, including the proliferation of no-money-down and interest-only mortgages; the soaring growth in the volume of new houses for sale, which houses do not yet happen to exist; and the growing imbalance between rising supply and sated demand. As for the second and third items on the list, students should consult a May 25 report by Francois Trahan et al. of Bear Stearns, "REIT All About It: A Bubble Looming in Real Estate?" Trahan's thesis is that 2005 is a uniquely risky juncture in real estate. Never before have homeowners been so leveraged; and never before has the residential market been so speculative. And, yes, he's bearish on REITs.

Which brings us to the centerpiece of the investment case against houses. R. King Burch, the originator of the forthcoming analysis, is a paid-up subscriber in Honolulu. As might be inferred from the title of the scientific essay quoted above, he was trained as a marine biologist, but made a career switch to real estate (he was intrigued to discover in business school that investment mathematics resemble the math used to express the dynamics of fish populations). He participated in the Japanese-financed Hawaiian property bubble of 1988-90, worked on hotel deals in Florida in the 1990s and wrote—among other real-estate-relevant works—"The Internal Contradictions of Hotel Real Estate Investment Trusts" (*Real Estate Review*, Fall 1997). Today, he consults and invests for himself in Hawaii. Either house prices are in a bubble, Burch advises, or, if not that, "at least something very different from the usual home buying activity that goes on in the U.S. economy."



source: The Bloomberg

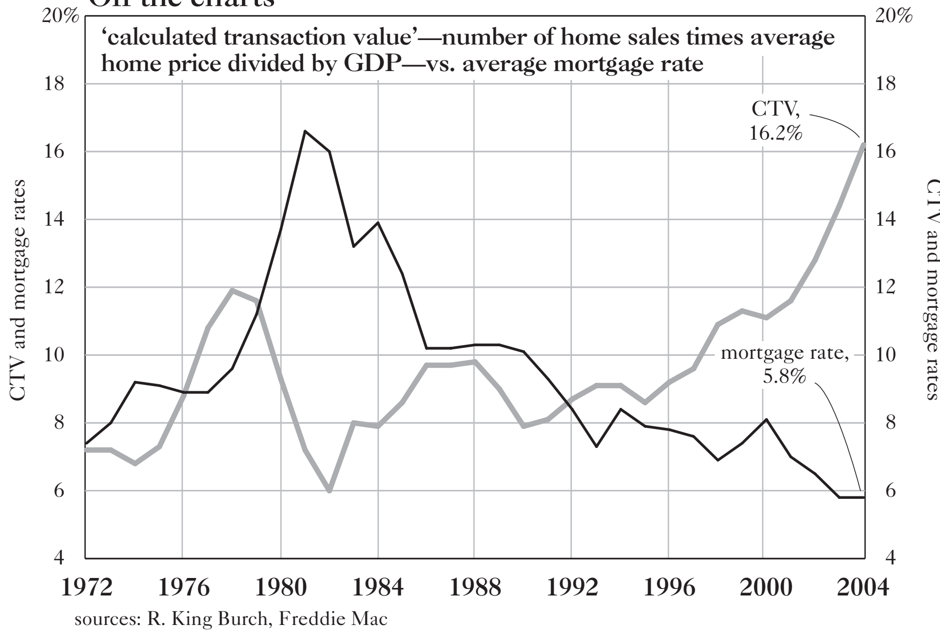
We believe that Burch has proven the bubble case, with all it implies for a future slump in the prices of the roofs over our heads. Like many another eureka, this one is calculated to make the reader say, "Now why didn't I think of that?" To draw a bead on U.S. real estate activity, Burch suggests, just take price times volume: Multiply the number of home sales by the average home price. Now divide that value by GDP. The answer expresses the intensity of house fever. Call this measure, as Burch does, the "calculated transaction value," or CTV. Now examine the findings, 1970 to date, plotted nearby. Do you spy a bubble?



source: U.S. Census Bureau

For 35 years, 1970 to 2005, the annual CTV—price times volume, both of existing and new houses—averaged just under 9.2% of GDP. "However," Burch relates, "the data show two periods with remarkable divergences from this mean. The first such period occurred in the inflation-led housing frenzy of the late 1970s, when transactions jumped from early-decade values of around 7% and peaked at nearly 12% in 1978. However, a nudge from Paul Volcker and 16% mortgage rates sent it plummeting back down to 6% of GDP by 1982." Significantly, Burch goes on, the decline was owing not to any fall in average prices, but to a 50% plunge in the number of sales: "Housing transactions then spent the next 15 years ranging from about 8% of GDP to just under 10% of GDP."

The breakout year for the current house-price boom is 1998. Except for a small stumble in 2000, the CTV has made a succession of new highs. It reached 16.2% in 2004, "a proportion," notes Burch, "that is 73%, and



2.95 standard deviations, greater than the average for the last 35 years." Not stopping there, it touched 17.2% at the end of the first quarter of this year, a level 85%, and 3.4 standard deviations, greater than the average for the past 35 1/4 years. If house prices are not a bubble, house transactions certainly are. Does your brother-in-law, the real estate broker, owe you money? Now is the time to collect.

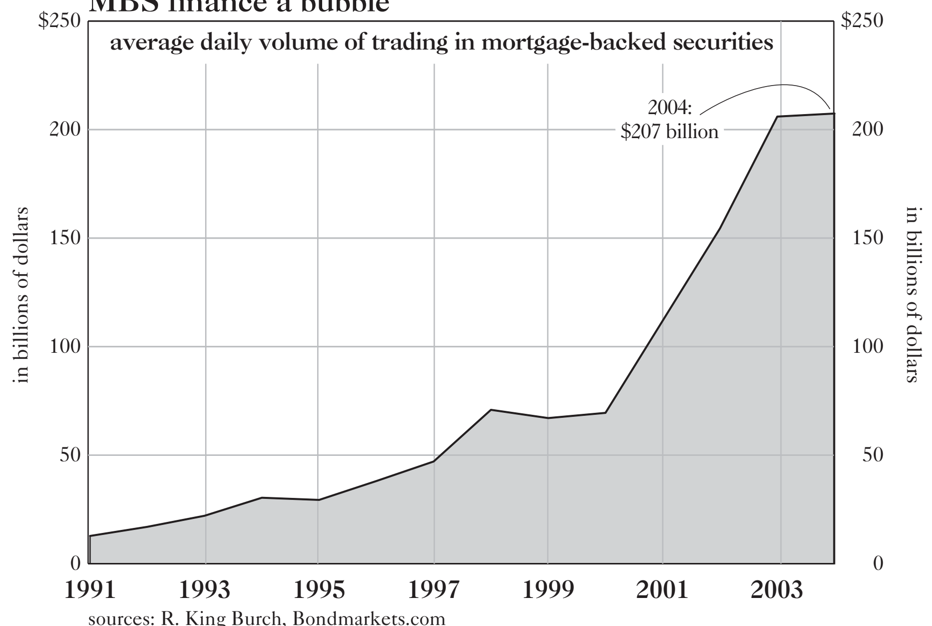
One might suppose that low mortgage rates are a sufficient condition for bubbling house prices. Burch finds otherwise: "A simple regression shows that average annual interest rates on conventional loans explain only about 30% of housing activity expressed as a percentage of GDP." Only consider 2004: CTV soared as mortgage rates stayed the same. Nor is the driving force behind the real estate bull market elevated income growth. Since 2000, growth in nominal wages and salaries has averaged 2.7% a year (5.9 percentage points lower than annual average growth since 2000 in the median price of an existing house).

What has driven the boom is rather the accessibility of dollars. For this monetary superabundance, the revolution in securitized mortgage finance, specifically the post-2000 lift-off in MBS activity, deserves thanks. Comments Burch: "The relatively recent advent and growth of an international market in mortgage-backed securities, whose buyers are neither especially knowledgeable of, nor concerned with, the credit and collateral of the borrower trumps the claim, valid in quaint earlier times when a neighborhood lender made and held local loans, that real estate markets are local." And while you're at it, thank the so-called carry trade (the tactic of borrowing at a low rate and investing at a higher, longer-term rate) and the shape of the yield curve (short rates conveniently below longer ones).

In times past, the home buyer had to apply for a loan. Now, the lenders almost apply to him, whoever he is. Can you fog a mirror? But wait, Burch cautions. A subprime-grade borrower availing himself of a no-money-down, interest-only mortgage confronts daunting arithmetic. Besides mortgage expense—call it 5% a year—the buyer must bear the cost of property taxes, upkeep and utilities—call that 2 1/2% a year. And say, at the end of year one, he decides to sell. He must pay a sales commission and other closing costs—call that 6.5% of the purchase price. Just to break even, therefore, our buyer-speculator requires 15% in price appreciation (calculated as [1.00 + 0.05 + 0.025/0.935]).

"Home prices and financing cannot continuously diverge from the buyer's ability to pay," Burch winds up. "Even the most aggressive MBS investors must eventually balk at funding towering home prices when the buyer has no 'skin' in the game. Since mortgage rates have, generally, stopped declining, I would bet (in fact, I have bet, by purchasing put options on home builders) that the game has already peaked." And the flatter the yield curve becomes, the tighter the lender's margins and the greater his risk.

We led off this article with the concession that bears on houses are thick on the ground. But how many of these doubters have taken bearish action? Your house-owning editor has not. The bearish Francois Trahan (co-



author of the Bear Stearns report) advises against precipitous action: "[T]here's no need to rush for the exits just yet; i.e., real estate, unlike stocks, is a slow-moving asset and none of this will unfold overnight." And from one of the top Wall Street research houses comes this optimistic article of pessimism: "[H]ousing is in a bubble, but [eminent economist's name withheld] places us in the seventh inning with plenty of upside potential." As long as interest rates stay moored, what's the rush?

But maybe the immediate risk to house prices lies not with interest rates but with lending standards, or the shape of the yield curve. Recall, as does Paul Kasriel, director of economic research at Northern Trust Co., the May 16 "guidance" from a brace of federal regulatory agencies to the nation's mortgage makers. The points of risk singled out by the bureaucrats are the very ones that have empowered the marginal home buyer to stretch to buy the marginal home (they include interest-only loans, high loan-to-value loans, low—or no—documentation loans and proliferating home-equity loans). A friend observes that the Fed resisted entreaties late in the 1990s to tighten margin requirements to deflate the stock-market bubble. Not literally deaf to its critics, the Fed—and the other leading federal banking regulators—might just be trying to take some of the helium out of today's bubble in house prices. It's no easy thing to deflate just a little bit. Good luck, *federales*!

'Club Med'
deficits and debts measured as a percentage of GDP

	Greece		Italy		Portugal	
	deficit	debt	deficit	debt	deficit	debt
1994	-9.4%	107.9%	-9.3%	124.8%	-6.6%	62.1%
1995	-10.2	108.7	-7.6	124.3	-4.5	64.3
1996	-7.4	111.3	-7.1	123.1	-4.0	62.9
1997	-4.0	108.2	-2.7	120.5	-3.0	59.1
1998	-2.5	105.8	-2.8	116.7	-2.6	55.0
1999	-1.8	105.2	-1.7	115.5	-2.8	54.3
2000	-4.1	114.0	-0.6	111.2	-2.8	53.3
2001	-3.6	114.8	-3.0	110.7	-4.4	55.9
2002	-4.1	112.2	-2.6	108.0	-2.7	58.5
2003	-5.2	109.3	-3.1	106.3	-2.9	60.1
2004	-6.1	110.5	-3.1	105.8	-2.9	61.9
2005e*	-4.5	110.5	-3.6	105.6	-6.8	66.2

*European Commission forecasts
source: Eurostat

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