

3<sup>rd</sup> Qtr. 2002

## Is There A Real Estate Bubble?

As a prospective buyer, if I knew prices were rising rapidly, then I might bid more for a home than it was worth. However if I knew that prices were dropping, then I might bid lower or I might just wait.

But buyers don't know what the future holds, they only think they know based upon very recent history. The moral is that buyers make value judgements based upon anticipated appreciation or depreciation.

With the NASDAQ bubble bursting, many articles have been written regarding a potential housing bubble. Some of the articles have pointed out that indeed in some cities there is a bubble. Greenspan was recently quoted as saying there isn't a bubble nationwide. However, some articles I have read cite certain cities like San Diego and Boston as looking pretty fluffy.

So how can we determine if there is a bubble? What is a home's true value? One method of valuation is to compare a home's mortgage payments to what a similar home rents for. Renters will not bid up rents above and beyond their true value, because they do not share in any future speculative benefit. Rental prices more accurately track true supply and demand. Rents aren't susceptible to wild price swings caused by speculative excess.

Comparing a home's total payment (mortgage, taxes & insurance - PITI) to renting a similar home, is a good way to determine the true commodity value of a home.

For comparison purposes let's choose an example of a \$400,000 home. Let's say it has 3 bedrooms, 2 baths, 1,600sf, a family room and is located in Los Altos. This home will rent for approximately \$2,000 per month.

Is \$400,000 a reasonable price for a home that rents for only \$2,000? Comparing your total monthly payment (PITI) to the rent will tell. If a buyer puts down 10%, the total payment with principal, interest, taxes and insurance (PITI) will be about \$2,700. Considerably more than the \$2,000 a month rent. But rent doesn't offer the tax benefits that home ownership does. Of the \$2,700 payment, \$2,300 will be tax deductible, resulting in a \$700 a month tax savings. In other words, a \$2,700 house payment is roughly equivalent to a \$2,000 rental payment. (see notes for details of comparison)

So the answer to the above question is housing prices are not out of line with respect to renting.

Two factors have kept the ratio of house payments to rental costs in check. Rental prices have climbed very aggressively since the Real Estate bottom of 1995. The \$2,000 rent in the above example was only \$1,300 in 1995. The second factor has been very low rates. This has allowed home prices to continue to climb over the last year, while keeping payments the same.

In the example above the rate was 6.25% percent for a jumbo loan. As recently as last year a jumbo loan was 7.5%. This lowers our example payment \$300. From a different point of view, the same payment now buys about \$45,000 more in Real Estate without increasing the payment.

How do these figures compare with the late 89-90 housing bubble? Back then many people were buying apartment buildings with high negative cash flow and homes for \$450,000 which only rented for \$1,500/month. Since they didn't have the benefit of today's low rates, there was usually a \$1,000/month premium after tax break to own. But the assumption during that period was that appreciation would easily make up for the difference. HA!

So today's relatively level comparison between housing payments (with tax breaks) compared to rental costs should give us some comfort that we won't be experiencing a NASDAQ like melt down.

This doesn't mean that I don't have concerns. Specifically, I have four concerns:

- 1) Rates are probably unsustainably low
- 2) The market does have cycles every 10 years or so and we are getting towards the end of this cycle.
- 3) The overall health of the economy & consumer confidence is a factor.
- 4) We are talking about a Real Estate bubble.

### Rates:

As I mentioned previously, the recent rate drop may have been responsible in large part for this last years market strength. But this also happens in reverse. Should rates move up then this will slow the pace of sales and prices may soften.

Is a rate increase likely? Well unfortunately it probably is. Rates are at there lowest level in 40 years, and being kept artificially low to help the economy recover.

The last year has seen a ton of activity, due in large part to rates being so attractive, people are persuaded to make a move now. But this steals from future activity. Like the automobile industry that is offering 0% financing, yes it moves cars and trucks off the lot, but when you already have a new car, you won't need one for quite a while. The same is true of the home buyers.

### Cycles:

Yes Mildred, trees do not grow to the sky, nor do Real Estate prices go up 20% a year every year, while incomes grow at 4% a year. There are several signs that the market is starting to moderate. Inventory is building, and it is taking longer to sell homes. I have also noticed a fair number of vacant homes on the market. Vacant homes keep prices in check, because often these

sellers need to sell. This is actually very good, What drove the market to new heights last year was a total lack of inventory. Literally there were no homes for sale and buyers bid up what little inventory there was. Having a balanced marketplace where a home seller can find a good trade up home is much preferable to one where you can't find another home to replace the one you sold. Having the market moderate now will also be much better for the future housing market, as a boom bust cycle can be avoided.

### **Economic Health:**

Part of what drove prices higher was the willingness of buyers to use a greater percentage of their income towards housing prices. At the bottom of the market buyers were scared and were very conservative with debt ratios. Often times keeping PITI to 25% or less of their gross income. Consumer confidence has obviously been great over the last 5 years, and buyers were willing to spend a greater portion of their income to purchase a home.

Should the economy falter and consumer confidence slip, buyers may re-evaluate how aggressive they want to be with a home purchase. Only time will tell on this issue as economists are pretty divided on this with a slight upward bias. The general consensus is that the economy will not go into a double dip recession and will come out slowly. On the other side of the coin, we have been dealt a huge blow with a stock market that is arguably the worst performance since 1987 or 1929. Like a prize fighter that has just sustained some massive blows, it might be hard for the economy to just get up and shake this off.

### **Bubble:**

Just the fact that we are talking about how there is no a bubble, is not good. It is like the scared little boy that whistles in the dark saying "I am not scared" *because he really is*. There have been a lot of articles written recently on this subject, most of them stating that there is no nationwide risk. So the harder we try to convince ourselves there isn't a bubble the more likely there is a risk. Ironic isn't it!. While there is some truth in this. I think the comparison of PITI to Rent is more applicable to local market trends.

The good news is that the comparison of PITI to rent does show that Real Estate is at least not wildly over inflated. So if the market does slow, the market will not behave like a bubble being deflated from too much hot air.

Notes on the PITI vs. Rent comparison:

- 1) The interest rate used to calculate the mortgage payment was 6.25%.
- 2) The tax savings assumes the buyer is in a 30% tax bracket.
- 3) The above comparison ignores two very important factors. The homeowner has lost interest income on the \$40,000 down payment. This loss is cancelled because now the buyer builds equity by paying down the mortgage each month. These two items were intentionally left out to simplify the example, but little accuracy is lost.
- 4) The other item missing is maintenance. While it is true that a tenant doesn't have maintenance costs, these are loosely offset by homeowner benefits like, pride of ownership, security and the right to future appreciation.