

WEEK OF MAY 22, 2006—RENT INFLATION

Who would have thought that real estate rents would begin to catch up to prices so soon? The April Consumer Price Index is saying so, as is one of Santa Barbara, California's largest property managers. Housing costs accounted for "about one-half" of the April index's rise, according to the Bureau of Labor Statistics, and caused the largest rise in the seasonally adjusted All Consumer CPI (0.6 percent) since January.

Other signs point to inflation being passed on to the consumers as well. Transportation costs were up 2.4 percent in the April CPI, airline fares rose 1.6 percent. In fact, only food and computer prices were flat.

Residential rentals have been the "tightest in 7-8 years," according to Santa Barbara's Bob Bartlein, owner of Bartlein & Co. Property Management, with units rented out "in a few days". But rents only began to rise last fall after being flat for several years as renters found it cheaper to buy their own homes, according to Bartlein. Now the reverse is true.

This is because the combination of rising interest rates and home prices is putting home owning out of reach for many California's inhabitant. So they have to rent. But it is also good for real estate, in that rents may finally begin to catch up to housing prices. And when rents catch up, it lessens fears of a bubble since the definition of a housing bubble is when prices no longer generate a reasonable return (i.e., via rents and capital gains) from real estate.

All markets fluctuate and real estate is no exception. Housing values in particular have been on a tear for 10 years, in part because of population growth and easier loan credit criteria, while residential rents have risen more slowly. Property values have even managed to stay ahead of inflation, fluctuating between 1-2 percent above the historical inflation average of 3.5 percent per year.

PPI & CPI—Inflation is beginning to rise in both wholesale (PPI) and retail (CPI) price indexes. The PPI for so-called Finished goods increased a whopping 0.9 percent, but just 0.1 percent without good and energy prices. But Intermediate and Crude materials' prices increased 0.9 and 1.2 percent further back in the supply pipeline, signaling that Finished goods' prices could also rise higher.

The Consumer Price Index caused more worry for markets and is a major reason for the current stock market sell off. It rose a seasonally adjusted 0.6 percent and core inflation was up a larger than predicted 0.3 percent, in part because of the above-mentioned rise in housing costs. The Federal Reserve may not stop the rate hikes if there is no sign that prices are cooling, since it may set off fears that inflation is out of control. And research has shown that inflation expectations tend to drive actual inflation.

HOUSING STARTS—Residential construction plunged 7.4 percent to 1.84 million annualized units in April. This corroborated the plunge in builder sentiment, reported earlier by the National Association of Home Builders. The NAHB/Wells Fargo builders'

sentiment index fell from 51 percent in April, to 45 percent in May. It was the first time it had turned negative since the Sept. 11 attack, and was the lowest confidence reading in 11 years.

**CONSUMER CONFIDENCE**—Consumers seem shaken by rising gas prices in May, said the U. of Michigan consumer sentiment survey. Its index plunged to 79.1 from 87.4 in April. The current conditions index fell 13 points, the largest one-month drop since 1978 when the survey became monthly.

Consumers may already be reacting to soaring gas prices, as overall retail sales rose just 0.5 percent in April, 0.1 percent excluding gasoline sales. And every penny increase in the gas price means about a \$1 billion reduction annually in consumer spending.

**INDEX OF LEADING ECONOMIC INDICATORS (LEI)**—The Conference Board's future predictor of activity predicted "moderate" near term growth, but no guarantees of future growth. Only 3 of the 10 LEI indicators increased, while factors like declining building permit activity, manufacturers new orders, and consumer expectations depressed the index. Most worrisome to this writer was that the Treasury yield curve remained flat, signaling a tighter money supply ahead. This is perhaps another reason the stock market has been plunging.

Santa Barbara's housing rents have increased approximately 10 percent in a year, according to Bartlein, as apartment construction has dried up and landlords convert more apartments into condominiums. Even Los Angeles rents have risen 7 percent in a year, more than double that of recent years, according to the LA Times. Yet mortgage payments have risen faster than rents, mainly due to the 16 Federal Reserve rate increases since June 2004.

Home sales are now moderating, especially in the most expensive markets. The National Association of Realtors recently reported that existing-home sales are down more than 15 percent year-over-year in the 5 hottest state markets. Sales have fallen 22.2 percent in Arizona, 19.2 percent in California, 18.2 percent in Washington, D.C., 15.7 and 15 percent in Florida and Nevada, respectively.

But the hottest real estate cities are still hot, like Phoenix, AZ up 38.4 in Q1 2006, vs. 48.9 percent in Q4 2005 and Orlando, Florida increasing 34 percent in Q1, vs. 42 percent in Q4 2005.

This is while sales in those states left behind in this boom are beginning to heat up. Year-over-year sales rose 15 percent in New Mexico, Louisiana, Montana and Mississippi in Q1, says NAR.

So a major reason for the rent increases is that mortgage payments are now higher than rents, making renting more desirable at a time when fewer rental units are available. The principal and interest payment on a conforming 30-year fixed rate loan amount of \$417,000 today, for example, plus taxes and insurance is \$2,939 per month. This can still buy a 2-bedroom condominium in some areas of the South Coast market. Average rents for that condominium are \$1900-2100 per month. Residential rents, therefore, have room to continue their increase.

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