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WEEK OF AUGUST 22, 2005—WHAT HISSING SOUND?

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> "Bubbles end when people stop believing that big capital gains are a sure thing. That's what happened in San Diego at the end of its last housing bubble: after a rapid rise, house prices peaked in 1990. Soon there was a glut of houses on the market, and prices began falling. By 1996, they had declined about 25 percent after adjusting for inflation.'
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> --Paul Krugman, New York Times, 8/8/05—

It depends on whom you talk to. Building and real estate professionals will tell you there is no housing bubble. Alan Greenspan now admits there is "froth" in some housing markets. And several economists, including Paul Krugman, Robert Shiller, and Chris Thornburg of the UCLA Anderson School of Business maintain that we will hear a hissing sound—rather than a pop—as the housing bubble slowly deflates, until incomes (and rents) have the chance to catch up to home values.

How long? Professor Robert Shiller, of Irrational Exuberance fame, maintains it might take 10 to 30 years for prices and incomes to reach an equilibrium. For him, as well as Krugman, any asset bubble is strictly a psychological phenomenon. Human beings have always had the propensity to fool themselves. (Isn't that what most psychological theory is based on?) This means that we humans allow ourselves to be swayed by others, or media-hype, or even our own unrealistic expectations.

Professor Shiller bases his thesis on historical data. He has compiled a graph in the second edition of "Irrational Exuberance" (Princeton U. Press, 2001) that tracks housing prices from 1890 to the present. It looks sickeningly like the stock market bubble of 2000, when the S&P 500 price-to-earnings ratio reached more than 40 to 1, before it plunged. P/E ratios had never reached that height before, including just before the 1929 market crash. The historical long-term stock average is actually 15-1, so corporate earnings must continue to grow to bring it back to the long-term average.

In the case of housing, Dr. Shiller's index shows that average housing prices adjusted for inflation have spiked almost 75 percent just since 2000. "This is the biggest boom we have ever had," said Shiller, in a recent New York Times article. "So a very plausible scenario is that home-price increases continue for a couple more years, and then we might have a recession and they continue down into negative territory and languish for a decade."

The case against a housing bubble is mostly based on the demographics of the baby boomers and echo boomers, their offspring. Each generation numbers almost 80 million, and echo boomers (who were born from 1980 to 1996, or thereabouts) are just entering the housing market. Couple this with the growing number of immigrant households, now 10 percent of our population, and you have the reason for the surge in housing demand.

It is clear that the recent stratospheric surge in prices on both coasts is the result of demand exceeding supply, whether the cause is real or psychological. Incomes have been rising for the top 10 percent income bracket of households—those with annual incomes of $150,000 plus, in particular—which is more than 13 million households. June and July homes sales were red hot. June's new and existing home sales broke the record and prices were up 15 percent, the biggest gain since 1980 when inflation was running at 13.5 percent, says CBS Marketwatch. And July is also a record month for new-home sales.

Another indicator of housing's strength is the jump in mortgage applications. The Mortgage Bankers Association reported that applications were up 10.6 percent over last year for the week ending August 12, while the dollar volume of applications is up 26.1 percent. "This increase is true for both purchase and refinance applications, no doubt reflecting the increase in home values over the past year," said survey director Michael Cevarr for the MBA.

The Conference Board's Index of Leading Economic Indicators is once again showing growth, because it chose to ignore the flattening Treasury yield curve that has brought the 10-year T Bond down to 4.18 percent and 3-month T Bill above 3.5 percent and rising. The money supply has also been steadily shrinking, which is one reason stock prices have been doing poorly. Both are signs of the Federal Reserve's attempt to reign in the money supply, hence tighten credit.

INDEX OF LEADING ECONOMIC INDICATORS—Six of the ten indicators used for the index showed growth, and the index inched up 0.1 percent in July, suggesting "moderate growth into the fall," said the Conference Board press release. But it is slower growth, as the index grew just 2.1 percent in the past 6 months, whereas it was growing 10 percent at the end of 2003.

NEW HOME SALES—New-home sales surged 6.5 percent to 1.41 million annualized units, another record. Still, only a 4-month supply of unsold homes remains on the market. And sales are up a huge 28 percent over July 2004. But the median year-over-year price fell to $203,800, which means builders are concentrating on the lower-end of the market.

EXISTING HOMES—The 2.6 percent dip to an adjusted rate of 7.16 million was still the third-highest sales ever. The 14.1 one-year percent median price appreciation to $218,000 is not sustainable, said NAR economist David Lereah.

Why even worry about a housing bubble? Most of us hang on to our houses for at least 4 years, and almost 70 percent are owner-occupied. It is the fact that housing has become almost the sole engine of economic growth that worries economists like Paul Krugman. He cites the contribution of home construction that has created 2 million jobs in the most recent quarter. Almost $5 trillion has been added to home values in the past 5 years, which generates maybe $150 million in additional spending and 1.5 million more jobs for affiliated industries.

Only military spending comes close at about half that growth rate, and how long will the Iraq War last? So, what happens when real estate slows, as well? It is borrowed money pouring into bonds from abroad that has kept interest rates so low. But foreign money isn't being used to enhance our productive capacity, as it did in the past 2 decades during the high tech boom. Investment in productive capacity outside of housing construction is now below the 1980-2000 average.

There is no question that our homes are our piggybanks. Homeowners have been borrowing $50 billion per quarter from their homes over the past year just through home equity loans. This is while wage earners received only $17 billion from pay raises over the last quarter, as we mentioned in a recent article. That is why America's personal savings rate has dropped to 0. It has happened once before in October 2001 after 9/11, as well as several quarters during the 1930s depression.

This is why incomes will eventually have to catch up with home values. Borrowed money is not savings, and cash is king during the hard times that inevitably follow good times.

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