

Blue Print of a Real Estate Bubble

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A couple of weeks ago a neighbor of mine put his home up for sale. This, of course, has become about as common in Reno as the wind. What was a surprise to me was that this same neighbor who purchased his home for \$475,000 exactly one year ago was now asking \$690,000. Now I admit to being out of touch when it comes to certain things, like my wife's birthday, but a 45% increase in home prices in my neighborhood was completely unexpected. Granted this home hasn't sold yet, but I know that the real estate agent my neighbor is working with has done his homework and has calculated the price per square foot compared to similar homes in the area. In fact, my neighbor tells me he is on the low end of the scale using a price per square foot valuation.

Some see this type of price increase and make the conclusion that they need to plow all of their money into real estate, similar to the behavior we saw in the dot com bubble. Behavioral economists refer to this type of behavior as "narrow framing," meaning that we take our experience over a short period of time and project it forward indefinitely. Even if we don't think the price will rise forever we at least think we are smart enough to get out before everyone else does. Ask your typical real estate market bull and they will tell you that real estate "always" goes up and that you "never" lose money. Anytime you hear superlatives in a sentence like that, you should put it in the same category as you do when your teenager accuses you in that whiney voice of "always" or "never" doing something for them. Exactly. Take it with a grain of salt.

Let's look at the bigger picture regarding real estate. First, the price of a home is subject to supply and demand. In the late 80's, the housing slump was a result of over-supply and falling demand. Many areas, especially on the coasts, saw a drop in values of 20% or more. Home prices have nothing to do with replacement costs. In Houston in the 80's, home prices fell to a fraction of what they had been only a few years earlier. Had there been a housing bubble? No. There was simply no demand.

Second, real estate is regional. Notice that when the dot com bubble collapsed the value of real estate in the Silicon Valley area declined, whereas major cities in southern California, such as San Diego, did not. The real estate price boom we are experiencing here in Reno and Sparks is not happening in the rest of the U.S. Currently, price appreciation is primarily occurring on the coasts. Take a look at real estate in the mid west and it's a different story.

Third, what drives real estate prices is demand and employment. According to John Maudlin, author of "Bulls Eye Investing," a reasonably good index of home values is national home prices compared with the national income over the past 40 years. Using this index, you can feel relatively "safe" in buying a home when the ratio is low. When comparing the average income to average home prices, we find that today the ratio is on the (quite) high end of the scale, implying the either home prices will drop relative to income or that income will rise relative to housing over the next few years. Given the recent lack of any upward trajectory of income, the study points to housing price weakness.

The NASDAQ in 1999 and 2000 was a bubble. Gold and Silver in 1980 was a bubble. Japanese stocks in 1989 were a bubble. The characteristics of most bubbles are a rapid rise followed by a quick drop. It is accompanied by rampant speculation and lots of stories why "this time it's different." Think of a line sloping upward that represents a gradual average gain in price year over year. Nothing too steep, just a gentle rise. Consider what price does in a bubble. It doesn't just get a little above the average growth line, it moves way above it. Now when prices fall, as they always do, they typically fall through the line for a period until the economy recovers or until

interest rates decline enough to provide a new stimulus. It then takes a long time at average growth trends for prices to get back up to where they were at the peak.

Some real estate bears have been pointing out that we have been in a real estate bubble for a couple of years now. I don't think they are necessarily correct. In other words, we may not be as far above that average growth trajectory when we consider factors such as additional demand created by emigrants into the U.S. I do think that all markets run in cycles, and that the real estate cycle we are in is likely closer to the end than the beginning. What does that mean for home prices? Barring a depression or a very long and deep recession, prices should move back to their average growth rate. This means that you might not get the growth you expect or you might not get any real returns. Taking a look at history, there are lots of times in every area of the country where housing prices suffered.

What is a home? It's where you live. It fits your budget and your lifestyle. It's where you raise a family or it's a comfortable place where you spend time when you are not working. Keeping a broader perspective on our home will likely help us make better choices.