The Mortgage Corner

WHAT REAL ESTATE BUBBLE?

> "In practice, there is no perfect definition of a price bubble; so, identifying a bubble in real-time is inherently a judgmental exercise. Indeed, given that bubbles always burst—if there is no burst, then there was no bubble—clear advance evidence of a bubble can never exist."
>
> --William Poole, St Louis Federal Reserve Bank President--

St. Louis Federal Bank President William Poole gave a rather optimistic prognosis for housing in 2006, pooh-poohing the possibility of a housing bubble about to burst. His optimism was tempered by the admission that St. Louis and the Midwest have never experienced a housing bubble. Real (inflation adjusted) St Louis property values rose just 5 percent per year over the past 5 years, versus as much as 22 percent per year in Los Angeles over that time. He also admitted that owning coastal properties carried more risk, in that there has been substantial property depreciation in coastal regions during past real estate downturns:

"Rapid house price appreciation on the coasts does not come without a cost, or at least a risk. For example, from the late 1980s to the mid 1990s, real house prices declined by 30 percent in Boston, by 36 percent in Los Angeles, by 20 percent in Washington, DC, but by only 11 percent in St. Louis. *In fact, since 1982, St. Louis has not had a nominal decline in house prices*. By contrast, it took Boston and Los Angeles approximately 10 years for their nominal prices to recover enough to restore prices to a breakeven level."

Then why the optimism? He believes that the FOMC will keep underlying inflation "low and stable", and the growth of real household income will "recover nicely" due to the waning influence of last year's spike in energy prices so that any real estate downturn will have a negligible effect on economic growth.

Fed President Poole seems to be echoing remarks made by new Fed Chairman Ben Bernanke, who believes we are in a 20-year period which he calls the "Great Moderation", when "both inflation and output volatility have significantly decreased." This has enabled the Federal Reserve to keep inflation expectations in check and interest rates in a narrow range, enhancing economic (and so job) growth.

"That said, some slowing in the *growth* of average home prices nationally seems a reasonable expectation at this juncture," said Poole. "Accordingly, the marginal contribution to the pace of consumer spending stemming from the wealth effect—that is, from households extracting a portion of their home equity to spend on goods and services—is not likely to be a significant concern. The reason is that other economy-wide developments—especially income and employment growth—typically exert a much greater influence on the consumer's pocketbook and spending habits than does the state of the housing industry."

Economic indicators are showing significant growth in the spring. With payrolls healthy and CPI inflation low, consumers remain confident.

INFLATION—The February retail Consumer Price Index rose just 0.1 percent, reflecting lower energy prices. Only health care and housing costs rose, while energy costs declined 1.2 percent. The wholesale Producer Price Index plunged 1.4 percent due to those same energy prices. Interest rates fell on the signs of lower inflation.

CONSUMER SENTIMENT—The U. of Michigan survey was unchanged from January, as consumers remain cautious. "Job growth in February was the second-highest in a year, and wages posted the biggest 12-month increase in more than four years, giving consumers the confidence to keep spending," said the survey. But rising interest rates and still expensive gas prices are a restraining influence.

HOUSING CONSTRUCTION—February starts fell 5 percent below last year but are still above the 2 million-unit rate. Permit growth was healthier, and is higher than last year. It means builders believe new-home sales will hold up in 2006.

President Poole's remarks may not satisfy the pessimists who believe that a severe economic downturn could trigger the bursting of a housing bubble. A book by a former Goldman Sachs investment banker John Talbott entitled, "Sell Now! The End of the Housing Bubble (St. Martin's Griffin, 2006, in paperback)," predicts that America's top 40 cities will face an average 47.2 percent decline in real estate values in the next 5 years.

Well-known economist Gary Shilling is another worrier. He states in a recent Forbes Magazine article, "The current housing weakness will develop into a full-scale rout…It's clearly a bubble and is nationwide…The house price collapse will induce a painful recession that will send U.S. stocks into a tailspin…China will suffer a hard landing…and weakness in the U.S. and China will spread worldwide."

Poole certainly has good reason for his optimism for the near term, at least, and who can really read the more distant future? Which is probably why renowned economist John Maynard Keynes once quipped, "In the end, we are all dead."

"If the evidence were clear, then everyone would know about the bubble and forthcoming burst," said Poole. "But then the buying that created the bubble would not occur in the first place. So, if you have an academic interest in house prices, I recommend that you wait a few years. If you have a direct financial interest, I can't help much—you're on your own!"