Popular Economics Weekly

WEEK OF OCTOBER 3, 2005—RISKS & REWARDS

What problem does Chairman Greenspan and his Federal Reserve Governors have with real estate? It is a risk and reward problem. Homebuyers are paying prices in some parts of the country that are not commensurate with the risks they are exposing themselves to. What are the risks? They could lose their jobs or real estate values decline precipitously, for starters. Interest rates could also rise to heights that make the house payments unaffordable, or some natural catastrophe could obliterate 200,000 homes, as did Katrina and Rita (and what insurance covers for every exigency?).

Greenspan stated in a recent speech to the American Bankers Association, "signs of froth have clearly emerged in some local markets where home prices seem to have risen to unsustainable levels." "…should mortgage interest rates rise or home affordability be further stretched," he continued, "home turnover and mortgage refinancing cash-outs would decline as would equity extraction and, presumably, consumption expenditure growth. The personal savings rate, accordingly, would rise."

It is the same irrational exuberance message Greenspan broadcast to stock market investors back in December 1996. No one heeded his call until 2000, when the Fed had pushed short-term rates to 6.5 percent and the Prime Rate reached 9.5 percent. It remains to be seen what impact his remarks and continuing Fed rate hikes will have on real estate.

The impact has been minimal to date. Consumers have cut back on retail purchases because of higher energy prices, but real estate sales and values continue to soar. Existing-home sales are up a huge 7.8 percent, and the median sale price rose 15.8 percent to $220,000 from August 2004-05.

The markets can actually measure risk, if investors will pay heed. The return on any investment is a measure of its inherent risk. Bonds are less risky than stocks, for instance. So long-term bond yields have averaged 4 percent annually, while S&P 500 stocks have averaged a 7 percent return since 1900 (including dividends and capital gains), according to Dr. Robert Shiller of "Irrational Exuberance" (the book) fame.

Real estate's degree of risk falls in between the two, with a national 5.6 percent average annual gain over the past 30 years, which is in line with average annual personal income and rent increases, according to Shiller. This means that in coastal markets where price appreciation has recently been 20 percent annually, there must eventually be a correction during bad times that brings values back to the mean, as last happened in 1990 to 1995.

Initial jobless claims rose to 390,000 for the week ending Oct. 1. A total of 363,000 people have filed for unemployment benefits as a result of the hurricanes, according to the Labor Dept. This is the first and most obvious impact of those disasters, but there will certainly be others, as yet unknown.

ISM FACTORY ACTIVITY—Sept. Institute of Supply Management's manufacturing survey jumped almost 6 points to 59.4 percent, probably because of the hurricanes. New orders, production, inventories and even employment rose. Materials' prices went stratospheric. This is obviously due to the rush to stock up, in case other natural or man-made catastrophes occur this winter.

SERVICE SECTOR ACTIVITY—The service sector survey plunged almost 8 points due to the hurricanes, on the other hand. Only 8 of the 17 industries surveyed actually grew. All sectors plunged, including employment, but prices paid also soared more than 14 points in services.

PERSONAL INCOME—Another effect was the 1 percent drop in personal income for August. And that was before the hurricanes. Sept. could be even worse. Much of it was a loss in rental income due to the storms, according to the Commerce Dept. Personal consumption also fell 0.5 percent, the largest drop since Nov. 2001 at the end of the last recession.

The alarm bells rung by Federal Reserve officials over the price jumps caused by the bad weather may only be temporary. But the projected budget deficits to pay for the damage will not be temporary. Especially if the costs reach $200 billion, or so, which will only add to the debts of future generations.