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The Week

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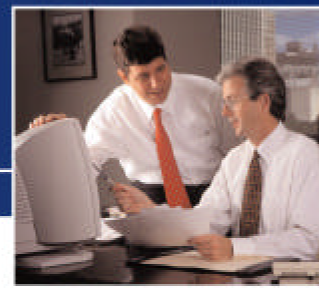

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House Prices: Leveling off likely, but no bubble to bust

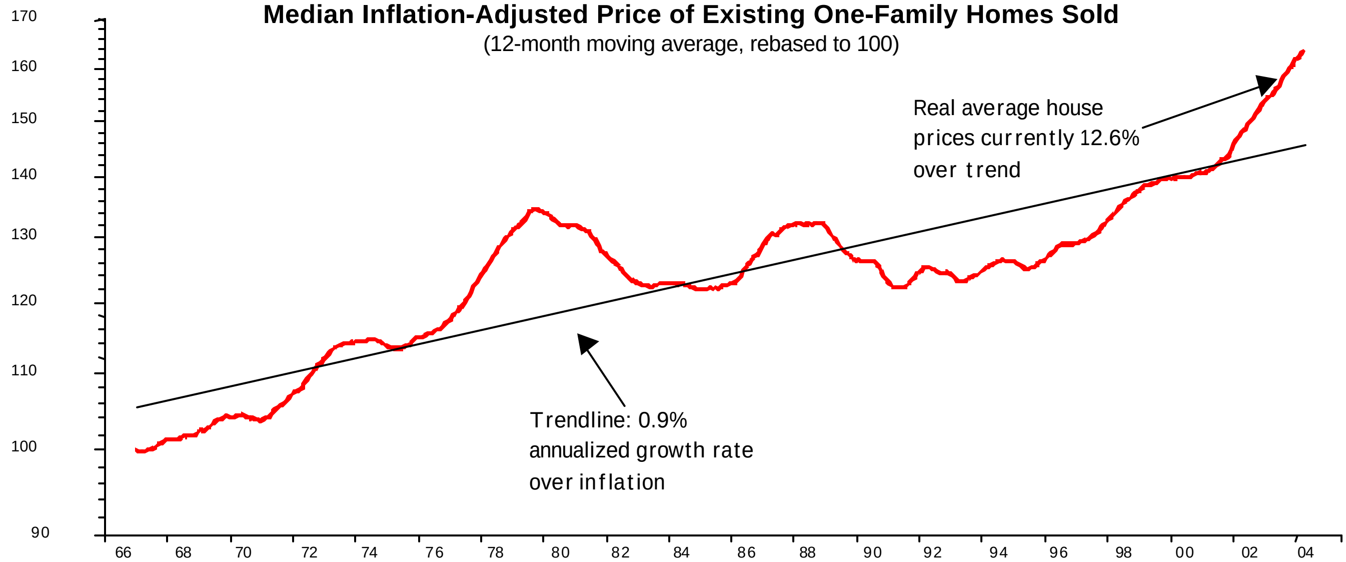
- Strong demand and tight supply characterized last week's reports on the US housing market. New home sales and existing home sales both hit record highs (demand) while the supply of new homes for sale fell to a record low (3.3 months of inventory at the current sales pace). Statistics like these have raised the question of a possible bubble in the housing market. We think those fears are misplaced. One feature of the late 1990s' tech bubble was speculative spending and infrastructure overbuilding. The housing market's tight supply refutes the concept of a bubble in homebuilding in our view. Another difference is the absence of a bubble in the valuations for home building stocks. Price to earnings and price to cash flow are close to three-year averages and although price to sales is near 16-year highs, a PS ratio of 0.6 times seems reasonable compared to the S&P Industrials' 1.53 PS ratio, in our view.

In search of a bubble. Take a trip to California or Florida where median home prices rose over 20% in the last year and talk to homeowners or potential homebuyers and they will both probably use the word bubble in the first sentence. But mention the words housing bubble to a resident of Kansas, Indiana, Ohio, Oklahoma, West Virginia, South Carolina or Arkansas, where median home prices fell in the last year and you'll probably get a blank stare. Housing is a local market and regional trends vary enormously in a country the size of the US, which makes understanding local supply and demand dynamics critical for investors buying individual properties. Analyzing the overall US housing market is relevant when trying to forecast the US economy due to the sensitivity of consumer confidence to house prices. The housing industry has enjoyed strong growth in both unit volume and prices for over 10 years. For an industry that has historically been cyclical, this should set off some warning signals with interest rates already rising at the long end and about to rise at the short end. Based on the rise in home prices relative to longer-term trends, debt servicing ratios and the ratio of median new home prices to median incomes we can make a case for house prices to be about 10% overvalued. While that should concern lenders who are financing over 90% of the value of homes, it is hardly a bubble.

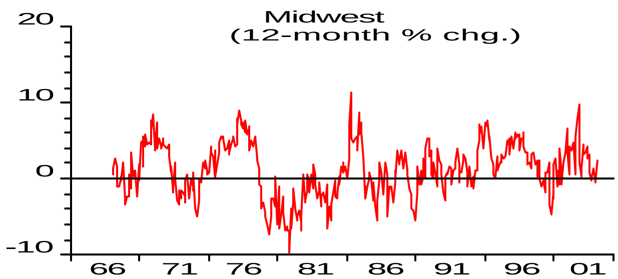
House prices look overvalued on longer-term trend analysis. Our data on US house prices goes back to 1967. Since that time house prices have risen at a trend rate of 0.9% over CPI inflation. Periods of high inflation and/or low real interest rates have been good for house price appreciation; recessions and periods of high real interest rates have caused prices to stall. Thanks to strong demographic trends such as population growth and the rise of dual income families, house prices have not declined on a national basis during this period. Looking simply at price appreciation, the greatest gains were during the last five years of the 1970s, when inflation was rising and before former Fed chairman Paul Volker caused real interest rates to rise dramatically in the early 1980s. However, in order to put the current period in a historical context we feel it is important to adjust for inflation and view house prices gains in real terms. On this basis, the gains in the last three years are just as strong as the late 1970s (see Charts of the Week). Consequently real house prices are about 12% above their 37-year trend. Real house prices' strong rise since 2000 is particularly impressive against the background of a recession, a weak employment market and subdued income growth. In our view the explanation for the rise is the combination of falling mortgage rates, the confidence induced by house prices rising every year over the last 37 years and the three-year bear market in stocks which caused investors to look for alternatives. Other valuation measures yield similar results. The median US home price is about 4.4 times the median US income, compared with a 26-year average of 4 times. Admittedly this relationship appears to be in a rising trend, but even the trend is only at around 4.25 times. Finally, *The Economist* magazine has estimated that US house prices need to fall 10% over the next four years to bring the ratio of house prices/wages and house prices/rents back in line with the 1975-2003 average, assuming wages rise at recent growth rates.

Conclusion. In our opinion, if house prices are around 10% overvalued, that hardly constitutes a bubble. However, we would not be at all surprised if house prices level off over the next 3-5 years to allow incomes to catch up with prices. We think the catalyst for a period of leveling off will be rising short-term interest rates, which will drive home affordability out of the reach of the marginal buyer. Those regional markets which have been the most frenetic in the last few years and which are not supported by strong local demographic trends, but rather by speculation and buyer capitulation, are most vulnerable in our view. From an economic perspective our conclusions are important. Countries that have experienced housing bubbles followed by sustained declines in house prices have often experienced prolonged painful recessions—for example the UK in the early 1990s and Japan for the last decade. If we are right and housing simply goes through an adjustment period, then the effect on the economy will be a reduction in growth rather than a recession in our opinion.

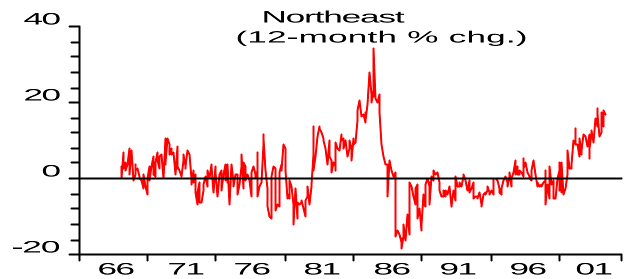
Charts of the Week: Real home prices above trend

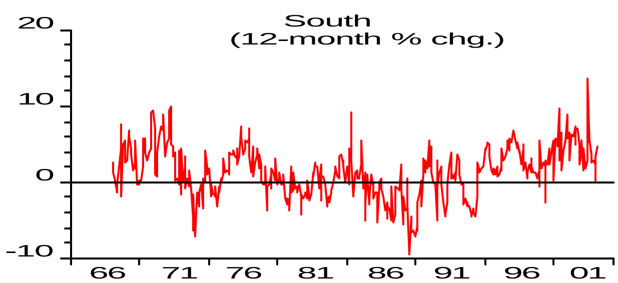


Regionally, real price gains have been modest in the Midwest and the South...

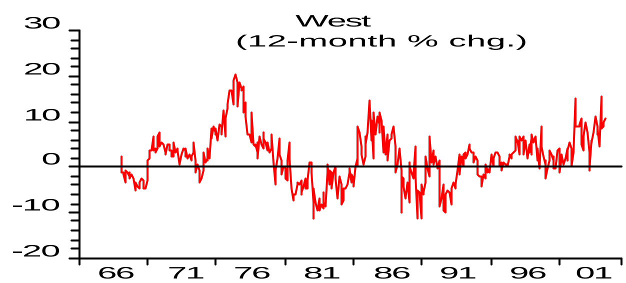


...the greatest year on year real price gains have been concentrated in the Northeast...





...and the West



Source: DATASTREAM

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