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COMMENTARY

What Housing Bubble?

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If you want to be scared out of your wits these days, you basically have two choices: go watch Steven Spielberg's latest, or listen to the hysterical warnings of economists and journalists about the imminent popping of our so-called housing bubble. Robert Shiller, the ubiquitous Yale economist, says home prices could fall 50% from their peak. Taking things a step further, *The Economist* recently went so far as to call the global housing boom "the biggest bubble in history."

In a free country, it is fair game for the media and economists to scare homeowners with words of gloom and doom, however knee-jerk, consensual and misguided they may be. But housing is a serious business; for most of us, it is our most valuable asset. For generations of immigrants, home ownership has represented the realization of the American dream.

The reality is this: There is no housing bubble in this country. Our strong housing market is a function of myriad factors with real economic underpinnings: low interest rates, local job growth, the emotional attachment one has for one's home, one's view of one's future earning- power, and parental contributions, all have done their part to contribute to rising home prices. Over the past quarter-century, there has been an explosion of second-home purchases, a continued influx of immigrants, and a significant reduction in existing housing inventory through tear-downs. Not all of these trends are accurately reflected in the unending stream of data published daily. Home prices on average have risen at a 6% annual pace since 1999, and 13% over the past year.

What we do have is a serious housing shortage and housing affordability crisis. Despite robust construction, unsold inventory stands at four months, well below its 25-year average. Private builders complain they can't get land permitted to meet demand. Low-income housing advocates complain housing prices are out of reach for many Americans, and that government subsidies have been slashed.

I am not an economist, though if you keep reading, you'll find I can use selective data points to my advantage with the best of them. I was a real estate reporter for this newspaper through several real estate crises, as well as a Wall Street REIT analyst; I am now a money manager. I currently own stocks in several homebuilders; so I am putting my money where my mouth is.

Of course, over the past 25 years we have seen numerous real estate busts. However, steep price declines have typically been driven by local economic factors -- oil woes lead

to weakness in Texas in the '80s; aerospace and defense layoffs soften up prices in LA in the '90s; a contraction on Wall Street hurts New York co-op prices.

What we have never seen in this country is a collapse of home prices without also seeing local economic weakness or significant capacity growth. Absent those factors, housing markets just don't collapse under their own weight. Herewith are some of the myths put forth by the housing bubble Chicken Littles.

- Myth #1. There is too much capacity: According to Census data, over the past 10 years, housing permits have averaged about 1.63 million units per year -- including multifamily units. Household formation has averaged 1.49 million families per year. So far, so good. But here is where the data gets murky. Roughly 6% of the new home sales were for second homes (I have seen estimates that the number is actually twice as high), according to UBS. And while there are no precise numbers on this, approximately 360,000 units every year were torn down either because they were nonfunctional, or because they were "tear-downs." When the latter two numbers are taken into account, the real number of new homes is closer to 1.2 million, or 19% fewer than the average number of new households formed each year.

- Myth #2. Risky mortgage products are fueling house appreciation: Sages from Warren Buffett to Alan Greenspan have warned of the increased risk from the use of new mortgage products, particularly adjustable-rate mortgages and interest-only mortgages. The theory here is that buyers are extending themselves to make payments, and when their mortgages reset they will be in trouble. Put aside the fact that only a year ago Mr. Greenspan was advocating the use of ARMs ("American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage," he told the Credit Union National Association last year), these concerns are wildly overstated. As virtually every mortgagee in the country knows, most ARMs are fixed rate for the first two to seven years. Virtually all have 2% interest-rate caps. The average American owns his home for seven years. Why pay several hundred basis points to lock in rates he is highly unlikely to take advantage of? Moreover, very little equity has been paid off by a homeowner in the first seven years of a 30-year loan, so consumers have been effectively overspending on interest rates for generations. As Mr. Greenspan said in his 2004 speech, "the traditional fixed-rate mortgage may be an expensive method of financing a home."

- Myth #3. Speculators are Driving Home Prices: The media today is chock-full of stories of day-trading dot-com refugees who have found their calling buying homes and condos "on spec," with the hope of flipping the property for a higher price. Earlier this month, one Wall Street analyst published an article with the catchy headline: "Investors Gone Wild: An Analysis of Real Estate Speculation." Scary stuff. Here, again, some common-sense thinking is in order. In Manhattan, where I live, friends buy apartments kicking and screaming, convinced they top-ticked the housing market. Is Manhattan special? Are speculators flipping Palm Beach mansions? Bay Area three-bedroom homes? Newton, Mass., Tudor homes? I don't think so. Yet these markets are experiencing the same price

appreciation as Las Vegas, Phoenix and Florida, where real estate investors are supposedly driving prices higher.

Anyone waiting for prices to collapse before buying a home is likely to be in for a disappointment. According to the Homeownership Alliance, new household formation, replacement demand and second-home demand will require about two million homes per year to be built over the next decade. This year, the number is likely to be around two million, the highest number since the 1970s -- even as the number of households has grown by over 50% since 1975. Therefore, there is a large cumulative deficit in housing that will take years to correct even if annual housing starts continue at these record levels.

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To the cynical, it is seductive to claim that every piece of good news is a bit fraudulent. And real estate has certainly been subject to boom and bust cycles. But bubbles happen when prices become unhinged from intrinsic value. Homes are not stocks; their "intrinsic value" can only be in the eye of the beholder. A house has utility. Rational people might be willing to pay more for a water view, or for living close to work, or for a larger lot. Such voluntary economic decisions are neither irrational nor exuberant.

It's time to stop being alarmist about home prices. To the extent policy makers want to modulate home-price appreciation, they would do well to relax zoning laws, or stimulate development of low-income housing through tax subsidies. Since those things are not likely to happen overnight, housing prices are likely to cool off slowly, if at all.

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