

The Bubble in Housing Prices and the Coming Bubble in Stock Prices by Donald Rowe

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Pick up any newspaper and you are likely to see stories almost daily about the real estate bubble. Here is a sample of recent headlines in Southwest Florida: "Housing Prices Soared by 36 Percent in March." "Developer to Build 10,000 Homes in North County." "New Condominium Sells Out on Opening Day." The housing boom began in the early 1980s after inflation and interest rates began a steady decline.

I remember my 12.75 percent, 30-year, fixed-rate mortgage in the fall of 1980—and that was not the top of rising mortgage rates. Today, mortgage rates are near record lows and mortgage applications are near record highs. The housing boom has evolved into a price bubble. Currently, California and Florida have the most cities with overvalued real estate problems.

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The following paragraph from the May issue of The Harry S. Dent Forecast, (www.hsdent.com) will capture your interest: "A sample of the cities that are the most overvalued in rough order are: L.A., San Diego, San Francisco, Santa Barbara, Las Vegas, Stockton (CA), Sarasota (FL). Miami, Palm Beach, Ft. Lauderdale, Naples (FL), New York, Sacramento, Boston, Portland, Reno, Chicago, Washington D.C., Denver, and Seattle.

Most of the Southeast and Midwest are undervalued or near fair value. Other cities in Florida, like Orlando, Tampa, and Jacksonville, look only somewhat overvalued, as does Phoenix, but not to the degree of other high growth Sunbelt cities."

When stock prices commenced a three-year decline in 2000-2001-2002, interest rates and mortgage rates plunged to the lowest levels in many decades. Hence, housing prices entered a bull market, while stock prices went the other direction. The steady migration of people to the Sunbelt, plus the demographic spending and investing of the largest and wealthiest generation in U.S. history are enormous influences on the real estate boom. However, all states are not participating equally in population growth, nor in home price appreciation.

Between 1990 and 2000, only 19 states grew faster than the overall country, which recorded a 13.1 percent population increase. Nine of the 19 fastest growing states are in the Sunbelt. Three states (Colorado, Utah and Idaho), with phenomenal growth, offer summer and winter vacation/resort living. Nevada, at the top of the list, offers a Sunbelt climate, superior tax advantages and retirement living for its residents.

Florida also offers a Sunbelt climate and no income tax. As a result, more people retire and bring their wealth to Florida than to any other state. More than 1,100 people move to Florida every single day. It is not surprising to hear of a condo or housing development that is sold-out on opening day. Not surprisingly, home and condo prices in Florida are soaring. There is a growing bubble in prices, but there is no inventory bubble, which will mitigate the fallout when air begins to escape from the bubble.

The first of the 77-million baby boomers will turn 65 in 2010. Between now and then, they will be looking for retirement and second homes in the Sunbelt and winter resort states, i.e., Colorado, Utah and Idaho. The relentless migration to the Sunbelt will continue into the next decade. Even with slower population, California will remain our most populous state.

Eventually, Texas and Florida will become the second and third largest states by population. Current media attention that speculates on when the housing bubble will burst is probably premature. But the stock market will give us some valuable clues: Fed Chairman Greenspan warned investors about the "irrational exuberance: of the rising stock market in 1996. Investors and Wall Street worried about the Chairman's warning all the way into late-1998.

Then, the final impressive surge of stock prices during 1999 convinced investors that stock prices were going to go up forever. The NASDAQ 100 jumped 99.9 percent in 1999, while the Dow Average soared by 25 percent. In May of 1999, the Dow Transportation Index rolled over and headed down. This was the first warning that the economy was slowing and a stock market top was sure to follow.

The M3 money supply began shrinking in January 2000, three years after Greenspan's warning. The Dow Industrial Average peaked on January 14, 2000, at 11,723 and then headed down for almost three years. The 2005-2009 economic boom will extend the real estate bubble and inflate stock prices to new highs.

There's the demographic spending and investing patterns of the largest and wealthiest generation in U.S. history. The euphoria of the economic boom and bull market during 2005 and 2009 will extend the housing boom into possibly 2008 or 2009. Unit sales of houses are already falling, but rising home prices are masking the top. At some point, rising interest rates during the 2005-2009 economic boom will slow what appears to be runaway home price increases in some states, i.e., California, Florida, Arizona and Nevada. However, by the end of the decade we could end up having to deal with the aftermath of two bubbles: one in real estate and another in stock market. Bubbles never end well. Stock prices and real estate prices will be overvalued well before 2010. Bull markets have a history of beginning during years ending in the number "5" (2005) and ending during years ending in the numbers "9" (2009) or "0" (2010).

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Stock prices will move from today's 38.7 percent undervalued levels to overvalued levels that will surprise even the technicians in 2009. An inverted yield curve in early- to mid-2010 will probably terminate the greatest bull market and economic super boom in U.S. history. During 2010, I expect the economy to rollover, along with stock prices and real estate prices.

First, I would expect the new Fed chairman to aggressively liquefy the banking system after the first signs of deflation in 2010. Dr. Ben Bernanke, the next Chairman of the Council of White House Economic Advisors and, quite possibly, the next Fed chairman, has already stated that deflation must never be allowed to unfold. To make his point, he dramatically suggested dropping money from government helicopters into every large city in America in order to prevent deflation. Second, Congress has learned that cutting taxes is the most efficient way to end recession.

Tax cuts always accelerate economic growth, which increases state and federal tax receipts. Accelerating economic growth between now and 2008 should balance the federal budget and eliminate the deficit by the end of 2008. The 1995-1999 economic boom produced record tax receipts and eliminated the deficit under President Clinton. Do you remember Congress scrambling to pass "balanced budget legislation" in an attempt to take credit for the balanced budget?

Congress did not cut spending! You will witness that humorous scene again in 2008 or 2009. During the recession of 2010-2011-2012, Congress will spend whatever it takes to keep our financial house together during the worst recession since the 1930s Great Depression. The federal deficit will soar. It always does during recession. Investors will have an enormous opportunity to multiply their wealth many times during the 2005-2009 bull market.

Making money will be fairly easy over the next five years. However, between 2010 and 2015, investors must shift their strategy to managing money in order to keep what they made during the bull market and economic boom. Making money and managing money are two entirely different skills. If the Dow repeats the gains from the 1995-1999 and 1925-1929 bull markets, the Dow could rise to 30,000 before the bull market ends in 2010.

Dow 30,000 sounds outrageous today, however, all progress is exponential, not linear. Unfortunately, we all tend to be linear thinkers and planners. Keep this in mind: The Dow Industrial Average tripled from 3,838 on January 1, 1995, to 11,723 on January 14, 2000. That is a multiple of three in just five years! With the Dow currently at 10,200, a multiple of three would produce Dow 30,600 by 2010.

Harry S. Dent is projecting a 38,000 to 40,000 Dow Industrial Average before the bull market bubble ends in 2010. Based on previous bull markets and the recession that follow, I would expect the stock market to lose 70 percent of its 2005-2009 gains before the end of 2013.

The market could then fall even lower during 2014. If history repeats itself, a modest, but weak rally should unfold during the "5" year (2015). Knowing how to short the Dow, the S&P 500, the S&P 400 Mid-Cap Index, the NASDAQ and the Russell 2000 will be valuable skills during the next downturn (2010 to 2015). ETFs (Exchange Traded Funds) are now the fastest growing investment tool.

By 2010, you should be able to short any stock, any market index, and any of the country funds from your computer. But that is another story on our list of things to cover in future issues of **The Digest**. Subscribers of **The Wall Street Digest** will not be surprised by the lift-off of the next great bull market, which has been only temporarily delayed by oil-price fears and rising interest-rates fears. Use the next five years to secure your financial future. In 2010, we'll shift from making money to managing money.

High quality corporate bonds will be one of the best investments after the market tops in 2010 because interest rates will be falling between 2011 and 2014. I am not concerned about consumer debt levels and there is no housing-inventory bubble. I am concerned about the financial instability that will unfold after 2010. Combined consumer and mortgage debt outstanding jumped from 65 percent of annual after-tax income in the early 1980s to 111 percent at the end of 2004.

What will that percentage rise to during the 2005-2009 bull market in stocks and the continuing real estate bubble? Consumer debt levels will rise dramatically during the great boom ahead. Mortgage debt is still rising. The following news item appeared on page one of **Investors Business Daily** on Thursday, May 12: "**Mortgage Applications Shoot Up**". The Mortgage Bankers Association's mortgage applications index leapt 9.4 percent in the week ended May 6, the biggest gain since mid-January.

Applications for refinancing and for buying a home both climbed more than 9 percent. The retreat in mortgage rates over the past few weeks seems to be lifting already strong housing demand. "Nationally, housing prices are currently 25 percent overvalued. What will that figure be when the housing boom suffers a serious correction beginning no later than 2011-2015? The enormous profits that you and I will enjoy during the 2005-2009 economic boom and bull market will be euphoric.

It will be financially devastating for those who do not liquidate all stock holdings by late 2009 or early 2010, and for those who own over-leveraged real estate.

However, a deflation in overvalued stocks and real estate is unavoidable between 2010 and 2014. Prices simply do not go up forever without a correction. The 2010-2014 correction in real estate and the stock market will not be pretty. It will be financially devastating for those who do not liquidate all stock holdings by late 2009 or early 2010, and for those who own over-leveraged real estate. Inflation is a debtor's best friend. Deflation is an illiquid debtor's worst nightmare.

Bankruptcies are likely to soar between 2011 and 2014. Use the next five years to pay-off debt. Eliminate credit card debt! Credit card financing interest rate fees are outrageous! Reduce the size of your mortgage. If you have an 80 percent mortgage and home prices fall 25 percent during 2010-2014, you could lose your home.

If you live in the fastest growing states, chances are that real estate prices in your area are overvalued by more than the national average of 25 percent. During the 2005-2009 economic boom, a global awareness will become increasingly important. China's problems are growing. Corporations are profitless and China's banking system is broke.

The sun is setting on Western Europe. Taxes are too high. Bureaucratic red tape has strangled European entrepreneurs and unemployment is stuck at unacceptably high levels. During the 2005-2009 economic boom and bull market, the U.S. dollar will be the strongest and most powerful currency in the world. Consequently, money will pour into the United States from

all over the world. *Don't worry about our rising trade deficit. We've had a trade deficit since before this country was born in 1776.*

America is the world's largest consumer! Foreigners would rather hold dollars than their own currency. That is why they aggressively purchased our Treasury bills, notes and bonds. The next five years will be an exciting and profitable ride. While you are enjoying euphoric, happy times again, be sure to dramatically reduce your debt levels.

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