

## **More on the Bubble in Housing Prices**

### **By Dr. Edward Yardini**

Federal Reserve Chairman Alan Greenspan retires at the beginning of 2006. My hunch is that the next Federal Chairman won't be Martin Feldstein, Ben S. Bernanke, or anyone else we know anything about. President George W. Bush is more likely to choose a Texas banker, a good-ol'-boy from his home state. Whoever does get the job may also get a heck of a mess in the home equity loan (HEL) market. Previously, I described HELs as financial weapons of mass destruction. This happens to be one of the few concerns that I share with the perma-bears.

The Federal Chairman cleaned up the mess caused by the bursting of the tech and telecom bubble by creating another bubble. This time it is in real estate finance. He refused to raise stock margin requirements to stop the previous bubble. Now he has failed to stop the alarming deterioration of mortgage lending standards to stop the housing bubble.

However, everyone "knows" that there is a bubble that could burst any minute, so it will probably get even bigger before it does so.

Of course, the bears have been saying that the housing bubble was about to burst for at least the past two years. I disagreed. I still believe that it won't pop anytime soon, especially since the Fed's recent campaign to talk up bond yields and mortgage rates has failed so badly. The Fed Chairman needs to warn mortgage lenders to tighten their lending standards voluntarily or else the Fed will work with other banking regulators to force them to do so. However, I doubt Greenspan will do so before he retires. So it will be up to the next Fed Chairperson whether the bubble inflates, deflates, or bursts. In any case, I don't see developments in the housing and mortgage markets causing a problem for the economy and stock market over the next 12 months.

Of course, before the housing bubble bursts, tighter monetary policy might cause a financial crisis elsewhere. This is a very good point that has been made by my friend Ed Hyman and his colleague Nancy Lazar at ISI Group. It is true that Fed tightening moves have usually been followed by a financial crisis. However, these events usually marked the end of the Fed's rate hikes. Moreover, they often coincided with major stock market lows creating great buying.

### **The Fed's True Conundrum**

I believe that Fed Chairman Greenspan and his colleagues actually are concerned about a housing bubble. This is why they launched a campaign to raise bond yields and mortgage rates earlier this year. If the members of the FOMC are really worried about inflation, why didn't they drop "measured" and just go for 50 basis points or at least prepare the markets for such a hike. Perhaps they are less concerned about inflation as measured by consumer price indicators than about the speculative bubble that is clearly inflating in the housing market fueled by excessive lending.

A few weeks ago, I wrote that the conundrum for the folks at the Fed is that if they tighten more aggressively, the bond yield and mortgage rates might actually fall. If the Fed is unable to raise the bond yield and if Mr. Greenspan won't stop the mortgage lending orgy, then the housing industry will continue to rock and roll. Why haven't bond yields soared on the Fed's cues?

The 10-year Treasury note yield was at 4.1% the day before Mr. Greenspan's conundrum testimony. It rose to 4.64% on March 28, 2005. Recently, it dropped back below 4.2%.

The 30-year fixed mortgage rate is currently around 5.8%, while the one-year adjustable is at 4.2% (Figure 3). Because interest rates remain near their historic lows and because lending standards are so lax, new applications for mortgages to purchase new and existing homes remain near record highs.

### **Home Sweet Home**

Let's take a quick tour of the housing neighborhood to assess the extent of the bubble:

1) **There is no bubble in housing stocks.** The 12-month forward P/E of Homebuilding was only 7.3 in April. This valuation multiple has remained below 10 since February 1999, even though earnings have tripled over the past three years.

2) **There is no bubble in the stock of new homes.** New home sales have been very strong in recent months. Homebuilders are building to demand so inventories remain very low relative to sales. In March, the months' supply of new homes for sale was only 3.6 months. Prior to the housing recession of 1990, the months' supply was often above 6.5 months.

3) **There is a bubble in mortgage finance.** There is plenty of anecdotal evidence that mortgage originators have lowered lending standards significantly in recent years. Margins are shrinking on all loans including mortgages as the yield curve has flattened. The lenders are clearly hoping that increased volumes will offset narrowing margins. To drum up business, many lenders now offer loans with all sorts of gimmicks:

- a. No down payments
- b. Home equity loans equivalent to the down payment
- c. Below-market teaser rates for a year on variable-rate loans
- d. Balloon loans that are interest-only for several years before any principal is due and
- e. Heavily discounted closing costs

With these incentives, it isn't surprising that the fastest growing credit at financial intermediaries is mortgages, which includes home equity loans (HELs). Home mortgages rose to a record \$7.5 trillion at the end of last year, up 13.5% from a year ago. They are up to a record \$2.7 trillion at commercial banks, which should be renamed *mortgage banks* since their mortgages well exceed the \$976 billion they have in commercial and industrial loans.

4) **The bubble in HELs is likely to get much bigger before it pops.** A home equity loan is money borrowed from a line of credit secured by the value of the home. Typically, the borrower pays the prime rate. The rate is usually lower when more is borrowed, according to the terms set by the lender. So going to HELs is seductive. The more you borrow, the lower the interest rate. If you can't make the payment this month, the bank will take what is due from the credit line. If more households tap more of their home equity – effectively turning their home into a credit card, then I can foresee that such a development could seriously exacerbate the next economic downturn.

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The actual aggregate line of credit undoubtedly exceeds the amount of HELs outstanding. This means that HELs account for roughly 12% of mortgages outstanding. Any way you slice it or dice it, banks and other financial intermediaries already have a very large exposure to such borrowing, and the exposure appears to be heading higher fast.

For now, the extra cash is boosting consumer spending and the overall economy. Last year, consumers borrowed \$196 billion from their home equity credit lines, or more than twice as much as from traditional consumer credit sources. Of course, some of the home equity borrowing may simply be displacing more costly credit card debt. This suggests that the credit card business is becoming more competitive and less profitable.

5) **There is a bubble in home prices.** In March, the median existing home price rose to \$193,600, up 8.7% from a year ago on a 12-month moving-average basis and 25% over the past three years. The one-year rate of appreciation now exceeds all previous cyclical peaks since 1982.

The Northeast and the West stand out as the most speculative and the most prone to a painful adjustment. Median price increases in the Northeast actually peaked at 17.8% on

a 12-month moving-average basis during June 2004, but still rose 14.1% in March of this year. During the previous bubble in the Northeast, home price gains peaked at 27% (also on a 12-month moving-average basis) during December 1987. By December 1989, they were down 10.5%.

In the West the median existing home price was up 14.4% in March, exceeding the previous cyclical peak of 13.4% during January 1988. I am not convinced that the housing bubble is about to burst. There are certainly many pockets of speculative excess in the housing market. However, everyone “knows” that there is a bubble that could burst any minute, so it will probably get even bigger before it does so.

6) **Housing's P/E is off the charts.** It is possible to calculate a sort of P/E ratio for household real estate by dividing the Fed's data on the market value of houses by disposable personal income. This ratio soared to a record high of 1.9 at the end of last year. On a trend basis, real estate values have been rising faster than incomes since the mid-1970s when this P/E was 1.1. Should we be worried? Falling interest rates tend to raise the stock market's P/E. The same is true for real estate. Lower mortgage rates mean that for any given income, people can afford to carry more mortgage debt and to pay more for a house. Home mortgages as a ratio of disposable personal income soared to a record 0.85 at the end of last year, more than twice as much as this ratio was 20 years ago.

So as long as mortgage rates remain low and personal income available to service mortgage debt doesn't decline, the housing bubble is more likely to get bigger than to pop.

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