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Have Houses Replaced Tech Stocks?

Observers have begun drawing parallels between the housing boom of the last decade and the technology and dot-com stock frenzy of the 1990s. In some places like Florida, Las Vegas, California and the New York metropolitan area, houses are being bought purely on speculation, with the conviction that prices will continue surging. Like the day traders of the last decade, some house buyers are even buying and selling in the same day in really hot markets. More frequently, people are buying second and even third homes; there seems to be a "can't miss" aura around real estate that has helped nudge many families to invest more of their personal wealth in real estate by taking on riskier mortgages.

So is there a housing bubble that could burst with rising interest rates? Certainly that's not the case nationwide, but there's mounting evidence that some areas are overheated. Three towns in Florida saw 35% to 45% increases in the median price of housing from first quarter 2004 to the same quarter this year. Nationally, the median price was up a high 9.7%, compared to historical rates closer to 3.5%. Over the past five years, homes have risen by 7.1% per year, double the long-term rate. Just last week Alan Greenspan, head of the Federal Reserve Board, was quoted as saying that there are a lot of local housing bubbles that represent an unsustainable trend.

The FDIC, however, analyzed the boom/bust cycle in real estate, and concluded that while housing booms like the current one do not last forever, as Greenspan said, most booms do not go bust but instead tend to result in a period of price stagnation. When you do tend to see housing busts (i.e. significant price drops) is where a local economy has experienced a severe economic shock. An example would be the "oil patch" cities of Texas in the late 1980s - - when oil prices plunged and thousands of jobs were lost, housing prices really took it on the chin. But it's reassuring to know that, at least historically, housing prices do not go bust simply because they've previously boomed.

Even so, it doesn't pay to become complacent and put all your money into real estate. There are, unfortunately, reasons to think that history might be a poor guide to the present situation. Things are different this time, and we should be cognizant of the factors. First, banks and lenders have been expanding as never before the market for what are called sub-prime mortgages. Such loans surged a huge 25% per year between 1994 and 2003. These are high rate mortgages given to people who otherwise would not be able to obtain a mortgage. While such practices have allowed millions of Americans who could not qualify for conventional loans to enjoy home ownership, it has also resulted in higher levels of delinquency and foreclosure. When interest rates rise, which they certainly will, such borrowers, many of whom have adjustable rate mortgages, will see their payments rise, which will put them in a real budget crunch.

Another phenomenon that's occurring is that people are extracting more equity than ever before from their houses, and many of them are funneling the proceeds into real estate investments. Americans pulled out roughly $705 billion of equity from their homes last year, up significantly from $266 billion in 1999. Nearly 2.2 million households used their home equity to buy additional real estate in 2004, up from 1.0 million a decade earlier. A large chunk of this money is in the form of equity credit lines, with rates tied to the prime rate. Those buyers will find their monthly payments rising whenever the Fed raises interest rates, which will surely continue to happen. Much of this money is being invested on the assumption that real estate never goes down; many experts are beginning to believe that the trend is speculative in nature.

So my biggest concern with housing is that sub-prime borrowers, adjustable rate borrowers and real estate speculators may put a real strain on the system, especially with all economists forecasting that interest rates (including the prime rate) will be rising for the next few years. What could conceivably occur, as budgets get strained with higher and higher payments, is downward pressure on housing prices, over and above the regular boom and bust concerns.

As Jan Hatzius, an economist at Goldman Sachs, recently said, "You should think pretty hard about whether you want to increase your exposure to real estate at a time when it is trading at historically high valuations." If you've read my bulletins and newsletters for more than a few years, you know that I occasionally talk about the "bandwagon effect" in stocks. That's when everyone jumps on after stocks have done well for a number of years, thinking that it's a sure thing. What ends up happening is that such investors are buying "high"; subsequently, when the market drops, they panic and sell "low." It could be prudent to think of real estate in the same light.