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Real Estate Market Heading For Fall

Even though the real estate market shows classic signs of speculation, few people believe it is in danger of an imminent downturn.

Many investors believe that real estate represents the best investment class today because the median U.S. home price has increased 51 percent since November 2001, and expectations are that it will continue to do so. If you look at a chart of single family housing prices around the United States, it is eerily reminiscent of the stock market in the late 1990's.

From an investment point of view, there is no denying the fact that it is better to rent than to buy today. If you can afford to buy a $400,000 house, you can likely find for the same monthly payment a rental house with a value of $600,000. Renting involves no risk of repairs or maintenance. When people retort that rental money is money down the drain, it assumes that real estate will appreciate. This is an assumption worth examining.

Here are some amazing facts that point to a speculative real estate market. After tax mortgage payments now consume nearly 20 percent of Americans' income. The last time this level was reached was in the late 1980's before a major recession descended upon the country. The housing boom has created up to 40 percent of the 2.3 million jobs added to the U.S. economy since 2001, and since then, real estate appreciation has been responsible for 68 percent of all wealth creation. The easy availability of loan money and the low standards applied to new mortgage loans has created a situation where the amount of down payments is approximately 9 percent! Adjustable-rate mortgages comprise over a third of new mortgages and no-money down, no-principal repayment loans are readily available so almost anyone can afford to buy a home, even people with extremely poor credit histories.

On one hand, this has made the American dream of owning one's own house widely available. The danger underneath this blissful situation is that sub-prime lending, i.e. the percentage of loans given out to people with a high risk of default, is about 17 percent. Consumers who own homes have borrowed $1.62 trillion against their equity since 2001 and spent about half of this amount to support lifestyle decisions. The danger rests upon the event that they are forced to pay it back when real estate values are falling.

Why do people think that real estate has to go up? First, it seems like a more secure investment than stocks and bonds because it is more tangible. Also, investigators tend to project out into the future their experience of the recent past. Almost everyone you meet will say that real estate has done exceedingly well, and they can see many "reasons" why this trend will continue. I am not so sure.

Stepping back and looking at the big picture, there were 2 million new homes built last year, but only 1.2 million new family households were created. The excess housing supply has been soaked up by investors. Currently, The Toll Brothers, the largest luxury home builder in the United States, has a 12-month, $5.9 billion work log of orders. Over time, the demographics of our country do not support such an increase in the housing stock. Neither immigration nor the kind of new jobs being created will sustain the prices of new homes at levels above what a typical family income can support.

What might a correction in the real estate market look like? Housing prices can adjust downward to a gradual slowing or flattening in the rate of appreciation, not just by a sharp drop in prices. This is because real estate is fairly liquid. Many people simply take their homes off the market if they are not satisfied with prices. However, when mortgage interest rates rise significantly, families who have stretched their budget in order to get into a larger home or have made an investment thinking that their retirement would come from real estate appreciation will be forced to sell at an inopportune time, and the selling frenzy will be self-perpetuating.

The Federal Reserve is acutely aware of the problems with overpriced housing markets. But, its ability to maneuver is so severely limited because of its past history of printing money that the Federal Reserve has no choice but to publicly deny that real risk abounds.

In 1998, beginning with the Russian currency crisis and subsequent Asian currency meltdown, the Federal Reserve and other governments' monetary authorities loosened that gates and flooded the world with easy money. This continued through the stock market meltdown of 2000, the terrorist attacks of 2001, and the subsequent mobilization of military in the Middle East.

An end to easy money will rock the real estate market through rising interest rates. Another real risk is a shortfall of cash flow on the part of borrowers.

The Federal Reserve has some control over short-term interest rates. If there is a disruption to the economy that causes consumers to retrench, the ensuing deflationary shock will not be able to be offset by the Fed's actions. If the housing bubble bursts, people will be reluctant to take on more debt, further slowing economic activity.

Insiders at the Federal Reserve estimate the economy will slow one-fifth of 1 percent for every 1 percent drop in housing values. A normal market correction would be 20 percent, so a drop in real estate prices can create a recession. If unemployment rises at the same time, that would further contribute an escalating break in housing values. Then, a rush to the exits on the part of impatient investors would create a further downward spiral.

If interest rates stay low, surplus cash worldwide will continue to flow into the United States for investment. This will continue to promote rising real estate values but at the cost of increasing our vulnerability to future economic downturns.

When mortgage debt cannot be paid off for any reason, you have the risk of deflation. Deflation is a dearth of demand, and it represents a serious threat to the world's peace and prosperity.

Once monetary authorities throughout the world decided in the late 1990's to inflate assets in order to assuage the public's anxiety, a real estate boom was inevitable. Now that it is going on, it seems to have no end in sight. It behooves people who are thinking about selling their home or have other real estate property that they need to turn into cash, to start moving in that direction now. In my experience, it is generally better to leave an investment party early rather than late.

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