INVESTOR'S GUIDE 2004

The New Home Economics

With heavier mortgage and tax rates looming, your one can't-miss investment—your house—may soon be worth less than you're counting on.

By Shawn Tully

(Illustration: Ross MacDonald)

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For the past five years the quality that has given residential real estate its magic glow is supreme "affordability." As interest rates kept plunging, Americans bought more and more expensive houses without increasing—sometimes even decreasing—the monthly mortgage payment that's the keystone of their financial lives. Put simply, what matters most to buyers isn't the massive but abstract price of a house. It's the checks they write for their mortgage and taxes. And it's those bargain "carrying costs" that enabled housing prices, for the first time in history, to keep rising right through a severe economic downturn. "In housing, Americans typically are buying a monthly payment," says Mark Zandi, a housing specialist with Economy.com. "So if rates fall, bingo! They're willing to pay $500,000 for a house that two years ago sold for $400,000 because the carrying costs stayed the same."

However, the very factors that lowered carrying costs—making home economics so alluring in recent years—now look foreboding. Turn off the football game, suburban homeowner, and listen up. The golden era of affordability is ending. The burden of owning a home has started to become heavier and will only get worse in the next couple of years. The reason is simple. The two main costs of home ownership, mortgage bills and property taxes, are on their way up.

Start with mortgage payments, the heftiest expense, which are linked to interest rates and which tend to jump with a rebounding economy. As the GDP has begun to percolate again, so has the cost of a new 30-year mortgage—which has already climbed 70 basis points in the past six months to 5.9%. And since the historical average is 7.5%, rates have lots of room to run.

Right about now, if you're one of those savvy consumers who had the wisdom last spring to lock in fixed-rate mortgages at four-decade lows, you're no doubt grinning, giving yourself a hardy pat on the back. But believe it or not, this nasty trend can affect you too. While your mortgage payment won't change, the rising tide of rates will absolutely affect the price you'll get if you sell your house. "If a buyer has to pay a point and a half more in interest today than a year ago, he'll pay less for the house," says Michael Sklarz, an economist with Fidelity National Financial, the big real estate services company. (Those who bought adjustable-rate mortgages are likely to get hit twice—once when their monthly payments spike up, and again with the sagging market value of their home.)

Property taxes may be less talked about around the water cooler, but they, too, are absolutely crucial to charting the future of home prices. Real estate levies are already swelling at double-digit rates in thousands of U.S. towns. And again, this trend isn't going away. The combination of falling federal and state subsidies and rising municipal spending leaves property taxes nowhere to go but up, up, up.

13 Reasons Not to Move
When it comes to property taxes, a few states go their own way. But we've scoured the country, and California's notorious Proposition 13 still takes the prize for the most uneven tax rules. As long as a house doesn't change hands, its assessment rises only 2% a year (established using 1975 prices). Once it sells, though, the value is adjusted to the market, and taxes shoot skyward. That means that a three-bedroom in Santa Monica that sold last year for $1.5 million is billed $16,300 in taxes, while a nearly identical house on the same block—but one that hadn't sold since 1978, when Prop 13 went into effect—is charged only $1,900.

So the question is, How much will the weight of those added costs push down prices? Here, the best guide is to view your house not through a sentimental haze as a beloved Colonial, but as a straight real estate investment like an apartment complex or even a stock. Think of the rental income you could get from your house as comparable to the cash flow from apartments or the earnings on stocks. True, most people don't rent their houses. But economists reckon that the rental value of a house closely follows the trends for apartment rents in the same area. Both are tied to the underlying economics. If a region creates a slew of jobs and companies boost wages, rents climb. Ditto house prices.

One way to look at the economics of your home is to use what we'll call a price-to-annual-rent ratio (or P/R), the rough equivalent of a price/earnings ratio for a stock. Like stock P/Es, they hew toward long-term averages. But also like P/Es, P/Rs can defy gravity and reason. Prices sometimes jump far faster than underlying rents, driving P/R multiples to extremely high levels. Danger looms when future rents look as if they can't grow fast enough to satisfy the market's Brobdingnagian expectations.

That's precisely what has happened. The P/R multiple is extremely high both by historical standards and compared with ratios for apartment buildings. Over the years P/Rs for both single-family dwellings and larger rental structures have averaged between 11 and 12. Since the beginning of the boom in '98, however, when both stood near 11, P/Rs for houses have blown ahead of those for apartment buildings. Rental P/Rs rose sharply with the strong economy, then fell with the recession. As rents dropped or leveled off, apartment prices cooled but kept the gains they'd registered from 1998 to 2001. Their multiples rose from 11 to around 13 in most markets.

By contrast, houses totally broke loose from the pull of falling rents. Prices just kept skyrocketing. Since 1998, P/Rs in the 20 hottest markets, including San Diego, Los Angeles, Denver, Boston, and New York City, have jumped, on average, from 11 to 20—an incredible 82%.

To be sure, housing prices had plenty of solid, logical reasons to soar. When interest rates plummeted, investors rightly decided that they could pay a lot more for houses and still do better than the meager returns on government bonds. What's more, once-onerous transaction costs for purchasing homes have shriveled. In the early 1990s banks charged two points to process the average mortgage; today the number is 0.4. And towns have been shrinking the supply of buildable land by restricting development. That's making it difficult for builders to meet the brisk demand for houses.

Those factors justify at least part of the explosion in housing P/Rs. The rub is that the main reason they've jumped—the steep fall in carrying costs—is already reversing. Once again, think of your house as an investment. If the expenses rise, the net rent, or cash flow, to investors shrinks. That effectively lowers the value of the building. Say a home in a hot market—New York, Denver, or suburban Washington, D.C.—is worth $800,000 today and carries a mortgage of $600,000 at 6%. The mortgage payment is $36,000 a year. In addition, the owner pays $22,500 a year in property taxes, not an incredible figure in the New York or Virginia suburbs. Total carrying costs are $58,500.

Let's fast-forward to 2005. Thirty-year mortgage rates now stand at, perhaps, 7.5%. Property taxes have jumped 20%. Suddenly carrying costs have soared to $72,000, an increase of $13,500. How much will that harm the value of the property? Remember, houses in strong markets carry a multiple to annual rent of about 20. So in theory, for every dollar their expenses rise (and their hypothetical rents drop), their prices fall by a steep $20. In our example, a jump of $13,500 in carrying costs would shave $270,000—more than 33%—from the home's value.

Before you start hyperventilating, remember that your house isn't actually a stock. It's unlikely you'll see such extraordinary drops in prices, since other market factors can play a role. Would-be sellers, for example, could simply wait out the drought until the market improved. "A lot of the adjustment would be absorbed by a collapse in sales volumes," says Karl Case, an economist at Wellesley College, outside Boston. "People with fixed-rate mortgages wouldn't want to give them up. They'd simply sit with their houses."

Economist Zandi predicts that while housing prices in markets such as New York, L.A., and Denver could decline as much as 5%, prices elsewhere are likely to inch forward with inflation. That may not be dire, exactly, but for those who have been counting on their home as the bulwark of their nest egg, impervious to the vagaries of the economy and stock market, this news may come as a shock.

The one blessing in disguise, if you can call it that, is that logic doesn't always rule when it comes to this quirky and emotion-driven asset class. "The market is so irrational that multiples of price to rent could go to 30 or more," says Case. Buyers might simply lust for properties so much that they'd swallow much higher carrying costs and still pay the same lofty prices.

Even so, one thing is certain. At these levels, there's very little gain left in the housing game, unless prices confound the experts, defy gravity, and just keep rising. The zealots call that the magic of real estate. To the rest of us, it's known as the greater fool theory.

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