A Reality Check On the Coming Crash

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John Talbott's recent book, "The Coming Crash in the Housing Market" (McGraw-Hill, 2003), might more aptly be titled "Potential Problems From Too Much Debt". Among the many truths the author reveals are:

- Americans continue to borrow too much using housing as collateral.
- Subprime, riskier mortgage lending is more prevalent.
- Freddie Mac and Fannie Mae could run into big problems if interest rates increase dramatically and the value of their portfolio assets suffer.
- Home prices in both real and nominal terms have increased relative to income.
- Rising mortgage rates will cause slower home-price appreciation or even declining prices in some housing markets.

Mr. Talbott's examples, based mostly on activity in coastal real-estate markets, correctly illustrate the huge ride-up in prices over the past few decades. However, he fails to point out the supply-side constraints in such markets. For a variety of reasons -- some physical, some political -- most southern California housing markets, for example, don't have a lot of new-home construction due to strict building-permit requirements. This helps to create higher housing prices relative to local income growth.

In addition, in most higher-priced real-estate markets, seasoned homeowners are less sensitive than Mr. Talbott suggests to interest-rate changes and less likely to default if home values decline slightly. For example, in La Jolla, Calif., where the average home-sales price exceeds $1 million, the average initial (at time of purchase) loan-to-value ratio is less than 63%, according to public records of home sales, suggesting home buyers in this market start with significant equity, probably from the sales of their previous homes.

Though well-documented and thoughtfully written, Mr. Talbott's book also falls short in pointing out some major factors in housing-price dynamics. At times the author veers towards the sensationalistic, suggesting some expensive and paranoid strategies that most Americans would be ill advised to follow.

Short-Selling Seldom Makes Sense

Mr. Talbott's assertion that short-selling -- selling a home when prices seem to be at their peak, renting, and then buying again when it seems prices have bottomed out -- can be advantageous in the real-estate market is advice we would be loath to agree with. Whereas the logic of selling short can be compelling in the stock market, where prices may be hundreds or thousands of times rational fundamental values, this strategy seldom works with real estate. Here's why.

Transaction costs in real estate are enormous compared to selling a stock-market investment. For example, if you sell $200,000 worth of stock in one trade, the fee likely will run no more than $1,000 or 0.5% of the asset value. But selling a $200,000 house may cost 7% in fees or about $14,000, plus the cost to clean and repair the home before listing it for sale; the time involved in finding an agent to sell it; the time and cost involved in planning, packing and executing a move; time spent changing addresses for mail and so forth.

Because of these transaction costs, short-selling strategies in real estate simply don't make financial sense unless the household involved is fairly certain that the average decline in home values will be well over 15% over the next two years. Such a decline is a rare occurrence.

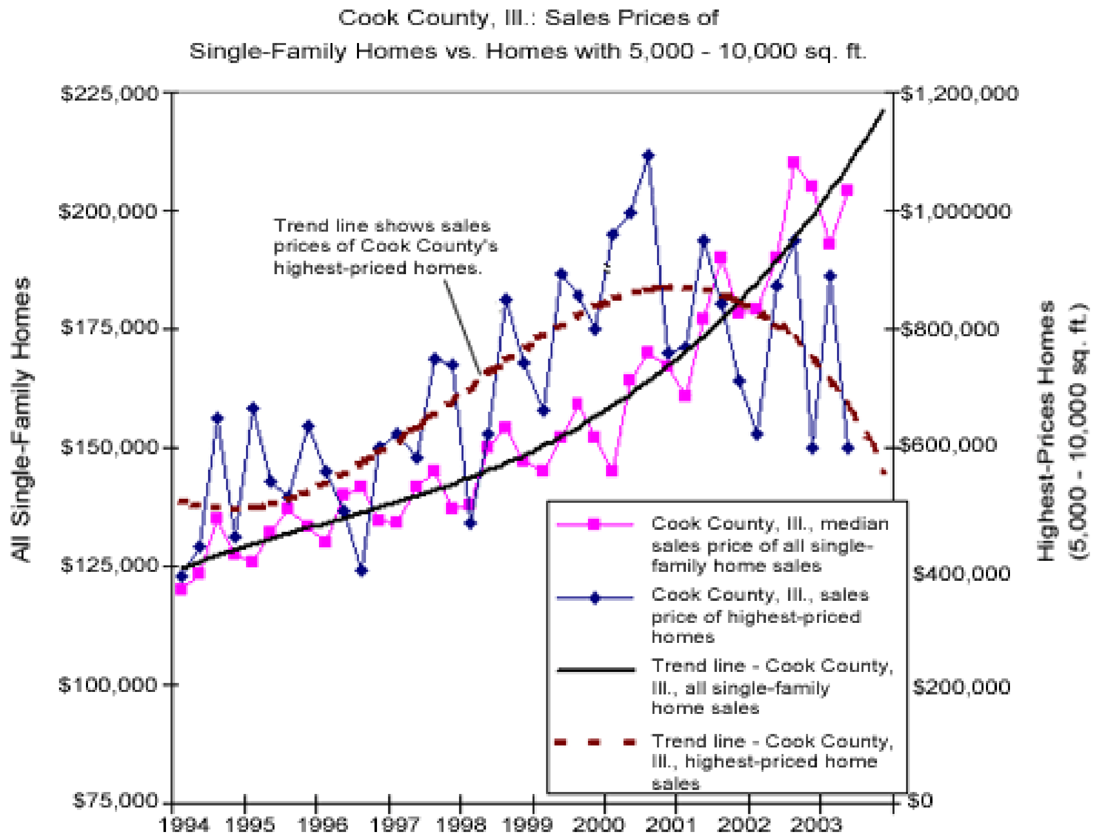
Will Higher Interest Rates Trim Home Prices?

Mr. Talbott correctly predicts that home prices can decline when interest rates increase, but this won't affect all homeowners equally. When interest rates increase, homeowners who locked in fixed-rate mortgages will see no increase in their mortgage payments. When rates go down, they refinance. Unless forced to sell, many homeowners ride out mortgage-rate upswings and wait for market stabilization. Prices in very few home markets will cascade downward because interest rates increase.

Too Late for a Cheaper Neighborhood

Some of the advice provided by Mr. Talbott, such as waiting to buy in selected home markets, makes sense. For example, we agree that the huge condominium supply coming on line in downtown Chicago over the next year may soften prices. But some of his other advice doesn't add up. For example, moving from a high-priced area to a low-priced area, at least in 2003, no longer makes sense. Housing prices in many luxury home markets already have peaked, so to sell now to move to a less expensive home would mean not selling at the top.

The data in the chart below illustrate this. Here are the home-price trends for greater Chicago's luxury real-estate markets, which we defined as the largest homes (5,000 to 10,000 sq. ft. living space). Even while median home prices climbed in 2002 and continue to do so in 2003, prices for an area's most expensive homes peaked in 2001 and have been softening, if not retracting, as the trend line in the chart shows. Prices for this area's most expensive homes started declining well before most people realized, and even before interest rates increased. This was simply a market adjustment, not unlike stock prices reverting toward more sustainable fundamentals. We have repeated this analysis of home prices in all major U.S. metro markets with fairly similar results.



Planning on Bankruptcy?

We agree with Mr. Talbott that consumers often have borrowed too much, but if a homeowner trades credit-card debt for cheaper, longer-term mortgage debt, we see that as progress. In this situation, mortgage default becomes less likely than when a homeowner holds a smaller mortgage and a large credit-card balance. We abhor personal-finance counselors who suggest using bankruptcy to eliminate past debts rather than taking responsibility for debt-incurring decisions. Bankruptcy may make sense for extreme cases, but better advice is to suggest building up some extra savings before taking on debt burdens of any kind.

Over the past few decades Americans have received some very appealing after-tax returns from investments in housing, especially on a risk-adjusted basis. Since 1986, the median home price has increased by 4.3% per year on average, according to the National Association of Realtors. This does not represent the total return from housing because owners also receive the "consumption benefit" of living in their homes. That is, houses provide such benefits as shelter and comfort even when property values decline. Where else can you find an investment that provides consumption benefits and maintains or exceeds inflation with so little risk? Housing remains a long-term viable store of wealth for many households and a solid investment for most.

Homeowners should relax and not lose sleep over predictions of a coming crash in housing prices. If the home you live in is among your area's most expensive, odds are your home's value already is down from a few years ago. It's too late to worry about selling at a peak. If you're a satisfied homeowner and interest rates do climb, be patient. Don't sell your home and start renting unless you simply like donating money to real-estate agents and landlords.

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