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STERLING'S WORLD REPORT

Home Sweet Home?

If there was a silver lining to the dark financial clouds of the last few years, it was that property markets did very well in most countries. For diversified investors, that meant losses in equity markets were often offset by gains in property markets. Accordingly, most indexes of total world wealth, which include both financial assets and real estate, recently have hit all-time highs.

Real estate booms around the world have been very helpful in generating economic recoveries because real estate is a far more important asset to most households than is the stock market. In the United States, for example, the median household has nearly 65% of its net worth tied up in its home, compared with only about 2% in equities. Cocktail party chatter in the U.S. has shifted dramatically from the late 1990s, when people bragged about how much their stock investments had made. Now one is more likely to hear conversations about the shabby property down the street that just listed for $500,000 and sold in two days.

Bubble Trouble?

Not surprisingly, all of this good cheer has produced serious talk of yet another asset market bubble, this time in home prices. Publications like *Barron's, Money Magazine*, and *The Economist* have all run stories over the past year or so about the irrational rise in home prices and the potential for a crash. The Economist gets the award for provocative titles, with a series of articles such as Castles in Hot Air, House of Cards, Bubble Trouble and Betting the House.

Even the sober International Monetary Fund (IMF) has gotten into the act, devoting several pages of its most recent World Economic Outlook to concerns about an "asset price bubble and thus the likelihood of a sharp price correction." It focused on the dramatic rise in residential property prices in Australia, Ireland, the Netherlands, Spain and the United Kingdom. As shown in Chart 1, most of those countries have seen real property prices rise at a significantly faster rate than real disposable income, suggesting that price increases might be outstripping fundamentals.

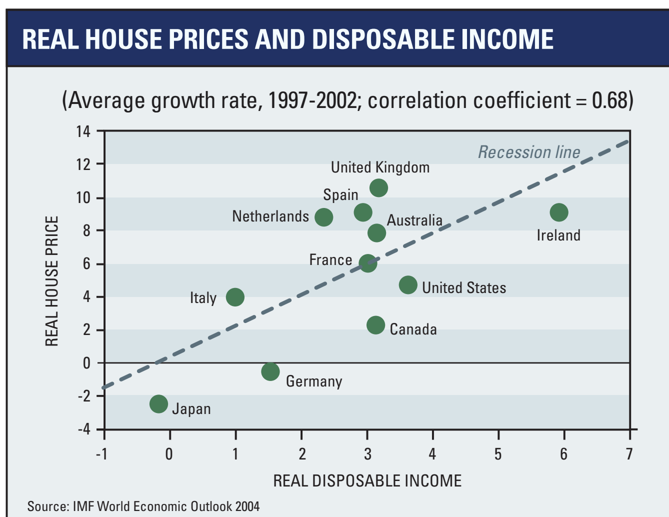

Chart 1: The IMF has recently expressed concern that home price increases in many countries have outstripped fundamentals like income growth.

Interestingly, Canada barely registered in the IMF's comparative analysis, reflecting the fact that Canada's housing prices have not experienced the same degree of appreciation as those of other major industrial economies. That doesn't mean that there has been no property speculation in Canada. For example, we recently read that the developer of a proposed downtown condo project in Vancouver had crowds line up around the block to buy properties that wouldn't be built for more than a year. However, having looked at Canadian home price data, our impression is that the issue of frothy property markets is likely to be much more serious in other nations.

Bubbly Data

We will focus on the U.S. housing market, since the consequences of a property bust in the U.S. would likely be

felt around the world. The good news is that housing remains readily affordable for most consumers, despite the significant rise in prices in recent years. According to the National Association of Realtors, low mortgage rates have offset the impact of higher home prices.

With mortgage rates still generally under 6%, many housing analysts believe that it would take a major rise in fixed-rate mortgages – say to 8% or above – to do serious damage to the housing market. Many bond market analysts believe that even if the Federal Reserve starts to boost short-term interest rates, bond yields and fixed-rate mortgage rates will rise much less. The reason is that the markets for longer-term funds have already priced in prospects for future Fed rate hikes and will therefore not need to adjust as much once the Fed begins to move.

That may well be true. But since prices are set "at the margin" – by whatever the last buyer is willing to pay – it is certainly likely that the dynamics of the housing market will change significantly as interest rates rise. In the short term, there may be a surge of home buying as consumers try to lock in loans before the cost of money goes up. However, looking down the road six or 12 months, it is almost certain that higher rates will begin to affect potential buyers' willingness and ability to pay higher prices for real estate.

Robert Shiller of Yale University, famous for his warnings about the U.S. stock market in 2000, has recently trained his sights on the U.S. housing market. He notes that the dynamics of property markets vary dramatically across the nation, and points out that the average home price in California has now risen to nearly 8.5 times average income. In contrast, the average home price in Wisconsin is less than 2.5 times the average income level – and almost always has been.

Shiller's analysis with respect to interest rates and home prices is straightforward. Suppose a family has to pay eight times their annual income to buy a home. Even with a low adjustable rate mortgage (ARM) at 4%, they would have to devote 32% of their annual income to servicing the mortgage (eight times 4%). Even a modest one percentage point rise in interest rates would raise the debt servicing cost to 40% of their annual income (eight times 5%), which could become nearly unbearable for many families. Hence the ability of the marginal buyer to pay a high price will rapidly disappear as interest rates rise.

Another way to look at the trend in home price inflation is to compare it to the overall trend in consumer price inflation. As we show in Chart 2, real home prices (adjusted for inflation) have risen by an impressive 30% since 1997 to a multi-decade high. We also show a trend line that suggests the underlying trend has been for real home prices to have risen by about 0.7% per annum since 1975. The most recent rise in home prices represents the biggest surge relative to that trend line during the entire period.

History shows that after other periods of a substantial rise in home prices relative to that trend, there have been lengthy periods of retrenchment – declines in the real price of homes. However, in the past, when overall inflation was much higher than today, much of the real price adjustment could be achieved by real estate prices moving sideways for a number of years while overall inflation eroded the real value of home prices.

Under current circumstances, if the Fed aims to keep overall inflation in the range of 1% to 2%, as is widely assumed, then any material adjustment of real home prices back toward the trend line in Chart 3 would imply that the overall level of home prices would fall – which is something that many mortgage credit analysts and real estate brokers tend to believe will never happen, mainly because it hasn't happened yet.

Of course, home prices have tumbled before in certain areas of the United States. In Texas in the early 1980s, falling oil prices led to falling real estate prices and severe problems for the savings and loan industry. In the early 1990s, real estate prices also fell markedly in places like California and New York. And, of course, Canadians experienced significant declines in real estate prices in the early 1990s.

Taking Aim at Fannie and Freddie

A nationwide decline in home prices in the U.S., were it to occur, would be a traumatic experience for the financial

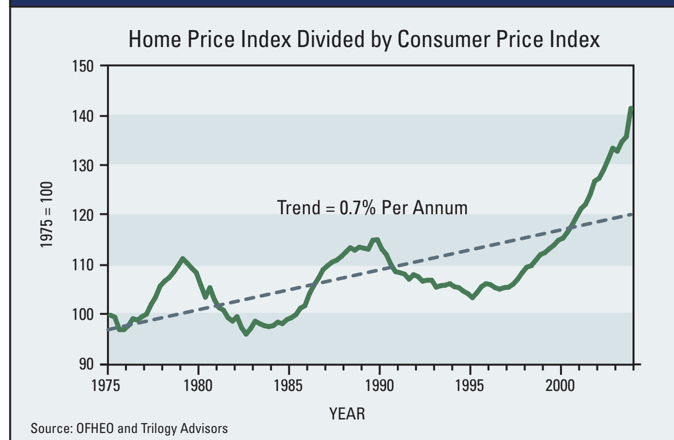

Chart 2: U.S. real home prices have soared by 30% since 1997 and are nearly 20% above the long-term trend line. Previous episodes like this were followed by a painful retrenchment.

system because of the dramatically increased importance of mortgage debt as a cornerstone of the system. As shown in Chart 3, total mortgage debt has risen at an impressive clip in the last decade and is now approaching $9 trillion. Home mortgage debt alone now exceeds $7 trillion. To put that in perspective, the entire stock of U.S. government debt is "only" about $4 trillion, so mortgage debt is now the tail that wags the dog of government debt.

This situation has not escaped the attention of government regulators, who want to bring the explosive growth of mortgage debt under control before they end up with major financial system problems. In particular, regulators are taking aim at mortgage giants Fannie Mae and Freddie Mac, which now own or guarantee roughly half of the outstanding U.S. home mortgage debt. Because both Fannie and Freddie are government-chartered companies, most investors have assumed that the government would bail them out in a crisis.

However, the Bush administration appears determined to bury the idea that the U.S. government stands behind Fannie and Freddie, despite the enormous political clout both companies enjoy in the U.S. Congress. Without getting into the arcane details of the debate over Fannie and Freddie's future, we would simply observe the following: If a huge expansion of mortgage debt has helped push real estate prices up dramatically in a low inflation environment, it is not likely to be helpful for home prices if the two giant lenders come under pressure to curtail their aggressive lending.

Does any of this mean that home prices are headed for a big fall any time soon? Not necessarily. As long as prices remain affordable at current interest rates, the demand for housing is likely to stay fairly robust. And even if Fannie and Freddie are pressured into curtailing their lending, other private sector lenders may well line up to take their place in extending credit to homeowners (albeit at less favourable terms to the borrowers).

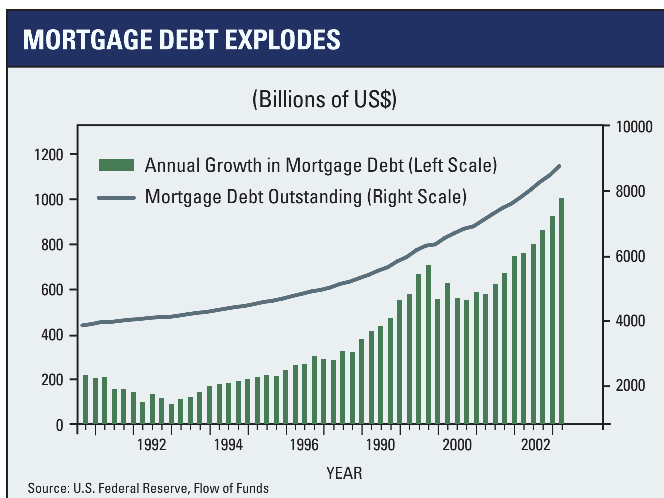

Chart 3: The annual growth of mortgage debt has risen nearly tenfold since 1992. This has fuelled the rapid rise in home prices and is now sounding alarm bells among regulators.

Moreover, once a large head of steam builds up in real estate markets, it can be difficult for central banks to change the trend without fairly draconian hikes in interest rates. For example, interest rates in Australia and the U.K. have been rising for several quarters now without having stopped the feeding frenzy for residential property in those countries.

Fed officials have made it quite clear that they will take their cue about increasing rates from overall data on inflation, growth and productivity. In other words, while they are concerned about potential overheating in the housing market, they will not raise rates just to puncture a possible home price bubble.

That said, for a variety of reasons, Fed officials are now clearly setting the stage to raise interest rates in coming months. And they are fully aware that higher rates will begin to cause some pain in the housing sector. Accordingly, we believe that the markets are in the process of experiencing an important sea change. Sectors like financials and consumer discretionary spending that were main beneficiaries of the Fed's aggressive reflation efforts are likely to be under some pressure as the Fed begins to take its foot off the gas pedal.

In our global equity portfolios, we are reflecting this view by tilting away from consumer and financial stocks in the United States. Instead, we are getting much of our exposure in those sectors in overseas markets like those of Europe, Japan and Asia, where governments need to continue to support growth while the U.S. throttles back.

As for home prices, we can only say let the buyer beware. Moreover, let the lender to the buyer beware as well. If there is a silver lining to this for equity investors, it could be this: After the sell-off in equity markets in 2000-2003, many investors have concluded that real estate is the only surefire investment. That conclusion may have drawn a substantial amount of money away from equity markets. It is now about to be put to the test.

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