

AMERICAN REAL ESTATE (THE MONEY JUNGLE, PART TWO)

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“The way earthly thin’s are goin’
Anything can happen...
So much trouble in the world...
So you think you’ve found the solution,
But it’s just another illusion!
(So before you check out this tide),
Don’t leave another cornerstone
Standing there behind...” “So Much Trouble in the World”, a Bob Marley and the Wailers song

CONCLUSION

The Federal Reserve Board regime of sustained rock bottom rates and massive quantitative easing has assisted American and international economic recovery. Gigantic deficit spending by United States politicians also has stimulated activity. Over the past couple of years, and particularly since around August 2010, the Fed and other American financial sentinels have encouraged dollar weakness. These policies have helped to boost stock and commodity prices sharply. The US of course is not the only player in the economic game, and these are not the only variables affecting economic growth in America and abroad.

Yet despite these economic rescue and repair programs, the continued substantial overall weakness in the US real estate marketplace reflects and warns of trouble. In particular, what do the housing sector and its consequences for the consumer balance sheet suggest? One should view real estate in the context of consumer confidence. The foundation for and structure of the recovery fabricated by the homespun policies of the Fed and the political herd is fragile. Although progress has been made, the shattering damage of the international economic disaster that commenced in 2007 has not been fixed. Though the worldwide economic recovery that emerged in spring 2009 is not entirely a house of cards, it’s also not entirely built on solid ground.

Nominal GDP growth is better than none at all, right? All else equal, money printing does not over time breed permanent real GDP growth. Also, deficit spending borrows from the future to spend in the present; it may boost current output, but at the end of the day, this factor primarily involves a shift of money between players and across time. All else equal, even if a slump in the broad real US trade weighted dollar benefits the US economy, that tends to undermine those of many of its trading partners. Holding policy interest rates such as Fed Funds low does not preclude higher yields later. Don’t those substantially in debt or suffering injury to their net worth often endorse easy money policies? Despite optimism indicated by rosy prices in the S+P 500 and lofty corporate profits, US real economic growth probably will be mediocre looking forward from now. What happens to American real estate still matters a great deal for the global economy.

THE US CONSUMER BALANCE SHEET

“Oh, people can come up with statistics to prove anything, Kent. 14% of people know that.” And: “Facts are meaningless. You could use facts to prove anything that’s even remotely true!” Homer Simpson

The roof fell in on United States household net worth during the worldwide economic crisis. The loss totaled about \$15.5 trillion from end 2007 to end first quarter 2009 (\$64.2-48.7tr). This awesome collapse exceeds full year 2010 nominal GDP of \$14.7tr. By end 2010, net worth had increased about \$8.1 trillion to 56.8tr. However, this still leaves it around \$7.4tr under 2007. (Federal Reserve Board, “Flow of Funds”, Z.1, Tables B.100 and B.100.e; next Z.1 release is 6/9/11).

Almost 90 percent of that 8.1tr net worth climb from the basement derives from \$7.2tr higher equity prices. Based on the 5.4pc S+P 500 rally from end 2010 to end 1Q11 (which is around current S+P 500 levels), net worth enlarged another trillion dollars.

However, **in contrast to the equity region, the US home front displays a tearful picture.** Let’s cut further into the thicket of the Fed’s Flow of Funds statistics. Owner’s equity in household real estate was about \$12.8 trillion at end 2006 (56.5 percent of real estate asset value) and \$10.4tr at end 2007 (49.5pc). By end 1Q09, owner’s equity had rotted away to just over \$6.0tr, or only 36.4pc of household real estate asset value. It rose almost one trillion dollars by end 2Q10. However, despite all the economic easing and extraordinary (even extravagant) government spending, by year end 2010 owner’s equity eroded about \$700 billion, leaving it at only \$6.3tr.

Consumers represent about seventy percent of America’s GDP. US consumer confidence (Conference Board) reached a floor at 25.3 in February 2009, not long from the S+P 500’s major bottom at 667 on 3/6/09. Although real GDP increased since end 2Q09, with 2010 up 2.9pc, confidence nevertheless expanded only to 72.0 by February 2011, well below the 111.9 in July 2007 at the height of faith in the Goldilocks economy. This significant yardstick has fallen since mid-winter 2011, with May 2011’s 60.8 even underneath the 61.4 valley of March 2003.

The current consumer confidence level and trend is a warning sign for equities and the overall economy. The S+P 500 made a final low back in 2003 on 3/12/03 at 789, way under current prices. Equity bulls and others might snort that 2011 is not 2003. Indeed, times change. And real estate and equities indeed are different marketplaces. It’s usually easier to buy some stock than a house. The US housing territory arguably is “less international” than the universe of stocks these days. Yet US housing and US (and worldwide) equities do intertwine, don’t they? Witness the recent global financial crisis.

Mediocre consumer confidence can derive from an assortment of interrelated factors. High unemployment surely is one, with the April 2011 headline rate at 9.0pc (Bureau of Labor Statistics). Weak household income trends are another. For example, real average hourly earnings have declined in five of the last six months (with the other month flat); April 2011 is down 1.2pc versus a year ago (Bureau of Labor Statistics). The federal deficit disaster (and in several states) does not make most observers joyous. Let’s not forget inflation concerns, including those derived from spikes in fuel and food prices. **However, ongoing substantial weakness in home prices probably plays a key role in the relative gloom.**

Debt remains burdensome for many consumers. So why be confident? So why rush out and buy a new or better house? Survey the NY Fed’s “Quarterly Report on Household Debt and Credit” (May 2011). Consumer indebtedness (of which mortgages represent a major part) is down from the peak level of third quarter 2008. However, at \$11.5 trillion at the close of 1Q11, it remains lofty (see p3 chart). And delinquencies remain high (see charts at pp8-9).

http://www.newyorkfed.org/research/national_economy/householdcredit/DistrictReport_Q12011.pdf

The S+P 500 is about twice the March 2009 valley. Improved business productivity (and thereby partly due to this, climbing profitability) surely has helped US equity prices to blossom. But money printing, low interest rates, a withered dollar, and stock buyback programs have been crucial instruments for the size and duration of the stock rally since March 2009. Incidentally, note the near-doubling of the NYSE margin debt; compare the \$321 billion in April 2011 with the February 2009 low of \$173bb.

In any event, weak home prices alongside plummeting consumer confidence (and other variables) suggest that at least a fair amount of the recovery and stock marketplace rally is not resting on a solid (genuine; real) foundation. First quarter 2011 US real GDP advanced only 1.8 percent, well under the Fed's sunny full year 2011 projection of 3.2pc (midpoint of central tendency; 4/27/11).

HOME ON THE RANGE

Let's gather a bunch of real estate indicators and spread them on the table. To what extent is housing gloom and related data old news? Some cackle that it is always darkest before the dawn. However, one also could assert that the sky could get even darker now. And in regard to the equity rally, one could say that things look bright at sunset before darkness buries the sun.

Anyway, although on balance the housing indicators still seem bearish, not all of them are. Glimmers of hope include an affordability index for existing homes, the April 2011 rise in the existing sales price, a low inventory for new homes, and signs (at least in some locations) that houses are not expensive relative to rentals.

From various perspectives, home prices remain rather decrepit relative to their pre-crisis pinnacle. Keep in mind that this feebleness exists despite a trend of generally declining mortgage rates since mid-2008, assisted by the low interest rate policy cooked up by the Fed. The 30 year fixed national average high was around 6.5 percent on 7/23/08 (Bankrate.com). Anyway, National Association of Realtors ("NAR") data reveal the April 2011 mean price (not seasonally adjusted) for existing homes is down about 22.2pc from the June 2006/June 2007 peaks. The median price is off even more from its July 2006/June 2007 summits- about 28.8pc. April 2011 existing home sales (seasonally adjusted) are down 12.9pc year-on-year.

Although the mean price of existing homes in April 2011 rose 3.5pc over March 2011, it is still 1.5pc under the December 2010 level. Median prices edged up 2.4pc versus March 2011 but remains 3.0pc less than December 2010. Thus there's probably still no net worth improvement to household net worth via housing relative to the December 2010 estimate. Moreover, will the recent further slide in consumer confidence reverse the April gain?

The Case-Shiller composite housing index edged lower again in March 2011 (5/31/11 report). At 138.2, it languishes about 33.1pc less than the July 2006 peak and slightly under the prior post-crash low of 139.3 in April 2009.

The Federal Housing Finance Agency's purchase-only House Price Index sagged 2.5pc in first quarter 2011 versus 4Q10 (seasonally adjusted; 5/25/11). This continues the unbroken string of quarterly declines that began in 2Q07. The 1Q11 index is down about 20.6pc from the 2Q07 pinnacle (p50).

The National Association of Home Builders/Wells Fargo Housing Market Index for May 2011 remains depressed at 16. January 2009 at 8 was its lowest depth. Its plateau in recent years was 72 in June 2005. It faded under 50 in May 2006.

Is there a silver lining to these price declines? The National Association of Realtors proclaims: "There has never been a better time to buy." ("Realtors Confidence Index", April 2011, p14). The NAR of course seeks to promote house sales. However, its composite Housing Affordability Index nevertheless has skyrocketed over the past few years. In March 2011, it is about 188, just under February 2011's 193. These 2011 levels are the highest for data going back to 1989 and almost double the low of 101 in July 2006 (full year 2010 average was 174, with that of 2006 about 108).

However, inventories of existing homes remain ample. According to NAR, there were 3.9 million at end April 2011. In months of supply terms, end April 2011 rose to 9.2 months from March 2011's 8.3 and January 2011's 7.5. However, this is still down from the sky-high 12.5 months supply in July 2010. Yet the various 2011 levels are all above calendar 2006's average of 6.5 months and the more typical inventory total of fewer than five months in prior years.

NAR reports in its "Confidence Index" that distressed property sales (foreclosures plus short sales) were 40 percent of total sales in March 2011, 37pc in April 2011. That sure makes for a depressing housing marketplace, yes? In a short sale, the sale proceeds fall short of the balance owed on the property's loan, but enable the borrower and lender to avoid foreclosure. Continued considerable liquidations risk further significant wounds to consumer net worth (and confidence) as well as to banking capital strength.

It is worth stressing the International Monetary Fund's ("Global Financial Stability Report"/"GFSR", April 2011; ch1, pp22-23 and Figure 1.24) mournful assessment in this context. The GFSR states that American "households are highly leveraged, with many in a negative equity position on their home loans" (p22). The share of residential mortgages with negative equity is about 23 percent. The shadow inventory of houses potentially for sale (in millions of loans) grew from around two million in 2007 to around 6.3 million in 2010 (or, about one in seven home loans). Judging from the GFSR, that total is approximately the current quantity as well. The IMF notes (citing CoreLogic) that in 4Q10, over 23 percent of US homeowners owed more on their mortgages than their homes were worth (Box 1.3, p43).

What about new residences (one family; Census Bureau, Dept of Housing and Urban Development; 5/24/11)? At end April 2011, only 175 thousand new houses were for sale (seasonally adjusted). This signals the weak housing environment, for it is the lowest for any month going back to 1963, and far below the July 2006 peak of 572m. However, and although there are stacks of old homes for sale, if the housing economy ever becomes more robust, this meager new homes inventory total may be perceived as a shortage. April 2011's 6.5 months of new home inventory is much less than the 12.1 months of January 2009, and the lowest since December 2006.

Although new home sales mounted about 7.3pc versus March 2011, they dove down 23.1pc versus April 2010. Over the past couple of years, the median US sales price has swung up and down from month to month (for example, \$204m low in October 2010, \$241m December 2010). April 2011's \$218m level falls well within the 2009 to 2011 range.

When many expensive houses sell easily and command increasingly higher prices, not only many realtors but also homeowners in general tend to become bullish about “real estate in general”. However, it appears that big loans for US houses may become more difficult for many Americans to acquire (NYTimes, 5/11/11, ppA1, 3). This event may add downward pressure on the top tier of the housing marketplace. Many fear the federal government will slash the price ceiling for which it will back (cover default risks) on new mortgages from current levels around \$725m. Loan limits were \$417m everywhere in the US in 2008, but the higher ones have been in place for the past three years. Legislators elevated them to help revive the deteriorating economy. Various formulas will determine new limits, which will vary around the country. The article says the limit in many counties will fall around 15pc. Some housing lobbyists are fighting to extend the current loan guarantees.

Let’s look through the window of the rental housing situation.

The US rental housing vacancy rate in 1Q11 was 9.7pc, up slightly from 4Q10’s 9.4pc and down from the 3Q11 high of 11.1pc (Census Bureau, Department of Commerce; “Residential Vacancies and Homeownership”, 4/27/11). Current 1Q vacancy rates are not low relative to the first quarter range of 7.5pc to 10.6pc for 1996-2010.

Apartments make up about half the nation’s rental supply, with single family homes and condominiums the rest. According to a USA Today story (online; 5/4/11), some gurus believe US apartment rents will ascend at least four or five pc this year.

However, US government data do not so far reveal a general rise in rent. The median asking rent in 1Q11 is flat versus 1Q10, and down 2.1pc from the full year 2010 average and 5.5pc from the 1Q09 top (Census Bureau, Table 11A; 4/27/11).

If renting become expensive relative to buying homes, that of course may encourage home purchases. The rent ratio is the average home sales price divided by the annual cost of renting an equivalent house. The appropriate breakeven rent to buy ratio varies according to the observer’s selection and evaluation of costs and geographic region. A NYTimes article (Business Day, 5/11/11, ppB1, 9) states: “As a rule of thumb, buying often makes more sense than renting when the rent ratio is below 15.” A small graph in the article places the US metropolitan area average at around 15, down from slightly over 20 around five years ago.

COMMERCIAL REAL ESTATE

“Don’t it make you feel bad
When you’re tryin’ to find your way home,
You don’t know which way to go?” “When the Levee Breaks”, by Led Zeppelin

A brief look at the US commercial real estate marketplace reveals carnage.

The Moody’s/Real Commercial Property Price Index lost 4.2pc in March 2011. That brings it to the lowest level since its October 2007 peak, a 47.0 pc bloodbath. (Moody’s; MIT Center for Real Estate; May 2011).

http://www.realindices.com/pdf/CPPI_0511.pdf

<http://web.mit.edu/cre/research/credl/rca.html>

The International Monetary Fund's GFSR (ch1, p26) underlines that US (and United Kingdom) commercial real estate "loan performance continues to deteriorate and prices remain depressed". Moreover, "refinancing needs over the next three to five years are daunting." A scan of Figure 1.30 indicates the US has a refinancing appetite from 2011 through 2015 that averages about \$350bb per year.

BANKS

"Oh, a storm is threat'ning
My very life today
If I don't get some shelter
Oh yeah, I'm gonna fade away." The Rolling Stones, "Gimme Shelter"

Given the still-weak home and commercial real estate marketplaces, the net worth of many banking institutions probably is vulnerable to marking-to-market of existing real estate loan portfolios. Renewed economic weakness of course would worsen that problem. In any event, banks nervous about their capital strength will not hurry to significantly expand their overall lending.

Let's dig into the underbrush of the GFSR in this context (ch1, p 11). "Estimates of potential property exposures vary significantly. First, real estate is of uncertain value in a number of markets, such as commercial real estate, where the number of transactions is low". **Now focus on the following remarks and then ask if the worldwide economic crisis is close to finished. "Second, some banks have been rolling over loans that would otherwise have been considered delinquent, a practice that may have been exacerbated by the persistence of low interest rates. Third, banks- particularly in the United States- have built up an inventory of repossessed properties, and a key challenge is how to reduce that stock without further destabilizing house prices...."**

Of the roughly \$13.4 trillion in total assets of US FDIC insured institutions at end 1Q11, loans secured by real estate were 31.0pc. So real estate loans of almost \$4.2 trillion are about 2.75 times bank equity capital of just over \$1.5tr. ("Quarterly Banking Profile", First Quarter 2011, Table II-A; 5/24/11). Even a five percent markdown (around \$210 billion) of these existing real estate loans would bleed bank capital dramatically. Maybe such a substantial asset writedown of real estate loans will never materialize (and maybe it will occur very slowly), but it's not unreasonable to consider. Is an even greater markdown worth contemplating?

Many American (and other) banks and real property owners probably lament the Fed's inability to buy real estate directly via its beloved quantitative easing enterprise.

POLITICAL ESTATES

In the film "Little Shop of Horrors" (Director, Frank Oz; 1986), Audrey II, the blood-loving person-eating plant of the floral shop demands: "Feed me!"

Not only does the US home and commercial real estate vista indicate that the US (and worldwide) economic crisis has not ended. As part of the desperate quest to solve the worldwide economic debacle unveiled in 2007 and thereafter- or at least to mitigate or postpone many of its

consequences- the US (and many other nations) encouraged (permitted) ballooning government budget deficits. Leverage and financial weakness thus were transferred from many consumers and institutions onto the public balance sheet.

Anyway, look at the White House and the Houses of Congress. Are the current and prospective deficits and official deliberations regarding them indicative of an orderly household? The President, Senators, and Representatives preach homilies about the virtues of fiscal prudence and the evils of excessive deficit spending. But what are they doing of substance relative to mammoth fiscal shortfalls? And the probable deadline of around August 2 for a debt ceiling increase looms.

Domestic deficit problems in the so-called European periphery of Greece, Portugal, and Ireland (and perhaps Spain) likewise may have global consequences.

GREEN ACRES

Some US real estate prices have not been hammered lately. Look at farmland. Not everyone complains about high crop and livestock prices.

According to the Chicago Fed (“Ag Letter”, May 2011), the sixteen percent year-on-year increase in farmland values for the Seventh Federal Reserve District in first quarter 2011 was the largest since 2007 and was last surpassed in 1979.

http://www.chicagofed.org/digital_assets/publications/agletter/2010_2014/may_2011.pdf

Also see the USDA’s chief economist on farmland (FDIC Conference, 3/10/11):

<http://www.fdic.gov/news/conferences/glauber.pdf>