

Desperate House Buyers

We have been reading and hearing more and more about the housing bubble and the inevitable fall in housing prices. Yet, long-term interest rates have remained in check while the Federal Reserve has been raising short-term rates, leading many experts to conclude that low mortgage rates are here to stay and the housing market will remain healthy for some time to come. This has ushered in the likes of www.condoflip.com, where condo pre-sales in major urban centers are being marketed “eBay style” to investors who want to make a quick profit by buying and flipping the real estate before the foundation is poured.

The residential real estate investing mania has become the “greater fool” theory at work and its days surely are numbered. In the book to be written on irrational investing, residential real estate will follow the chapter on dot.com stocks. Once again, there simply is too much cheap money available to speculators.

Years ago, I predicted a 50-year mortgage as a somewhat desperate measure that the economic policymakers could take in supporting the housing market in difficult times. That prediction assumed the maintenance of prudent lending standards. The 50-year mortgage is no longer a relevant consideration as the following has been allowed to occur in the mortgage industry:

- In 2004, the average down payment on a house was only 9%, i.e., the lowest in recorded history.
- In 2004, 24% of all mortgages were to sub-prime borrowers, i.e., those with bad credit histories.
- In 2004, only 49% of jumbo loans were fully documented, down from 73% in 2001.
- In 2004, 46% of all new mortgages were of the adjustable rate variety despite the availability of relatively low fixed rates by historical standards.
- In 2004, there was explosive growth in the use of option ARMs, which allows the borrower each month to substitute a regular mortgage payment with an interest-only payment or a partial interest payment resulting in negative amortization to principal.
- In 2004, 36% of all home purchases were either for investment purposes or vacation homes.

- In 2004, there were 2,000,000 new homes built for only 1,200,000 new households.

The obvious questions for the residential real estate market are:

- What if long-term interest rates start rising?
- What happens if the US enters a business recession whereby layoffs and wage cuts become commonplace?
- What if the deadly 2004 hurricane season in the Southeast US was not a fluke, or other geographic regions experience major floods, drought conditions or earthquakes due to changes in weather patterns and seismic activity?

In any of these scenarios, demand for residential real estate will be curtailed. This will lead to a halt in new construction and put hundreds of thousands real estate industry professionals and staff (who also double as homeowners and property speculators) out of work. A vicious price cycle will begin. This cycle will be exceptionally pronounced in those geographic areas that have experienced the greatest price appreciation, or in those geographic areas that are hardest hit either by an economic slowdown, adverse weather conditions or natural disasters.

Let me offer a few short answers to the questions posed above:

- Low long-term interest rates are not a lock. The future direction of interest rates will be heavily influenced by countries that finance our deficits. For the most part, these countries are located in the Eastern Hemisphere. Some of these countries are growing increasingly hostile to US military operations in various parts of the world (and in the far reaches of outer space) or are competing head-to-head with the US for finite supplies of natural resources.
- A business recession in the US will be caused by shrinking disposable incomes. This is becoming more and more likely as short-term interest rates are ratcheted up, energy prices remain at or near record levels, tax cuts are phased out, job markets remain stagnant and entitlement payments are delayed or reduced out of necessity.
- There is overwhelming evidence of global warming. Only the root causes are being debated. This is affecting climate and weather patterns the world over. We no longer can assume that the past will reliably predict the future and certain geographic regions will be at increasing risk from tropical storms, floods, drought and earthquakes.

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