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The Bubble's New Home

By JONATHAN R. LAING

YALE ECONOMIST ROBERT SHILLER delivers his forecast for U.S. housing with a scholarly diffidence that only slightly mutes his stark message: The market is in the throes of a bubble of unprecedented proportions that probably will end ugly.

Such unsettling talk is cheap, of course, especially from a tenured academic, and many sources, including *Barron's*, have wrongly predicted housing's downfall several times in the past few years. But the Ivy League professor's forecasts of coming trouble have been right before. His best seller *Irrational Exuberance*, predicting a bear market in U.S. stocks, hit the bookstores in March 2000, less than a week before the Nasdaq began a dizzying descent from above 5000 that would destroy 75% of its value in a little over 2½ years.

In the real-estate market, Shiller contends, a price slide could begin at any time with the crescendo of what he describes simply as "talk" -- a word that he uses to cover everything from the recent Time magazine cover story on the vertiginous rise in home prices and the popularity of cable-television shows about rehabilitating and investing in real estate to the breathless newspaper stories of Miami condos being "flipped" for profit a half-dozen times before construction even begins.

The No. 1 topic of cocktail-party chatter these days, after all, is that nothing beats a home as an investment because prices just keep rising while the owner gets to live comfortably at the old homestead until deciding to cash out.

"THE HOME-PRICE BUBBLE feels like the stock-market mania in the fall of 1999, just before the stock bubble burst in early 2000, with all the hype, herd investing and absolute confidence in the inevitability of continuing price appreciation," Shiller observes in the calm of his capacious office in a converted Robber Baron mansion on New Haven's stately Hillhouse Avenue. "My blood ran slightly cold at a cocktail party the other night when a recent Yale Medical School graduate told me that she was buying a condo to live in Boston during her year-long internship, so that she could flip it for a profit next year. Tulipmania reigns."

Shiller, like any economist of reputation, is somewhat coy about predicting how or when the housing bubble will deflate. With so much price momentum since the

Derek Dudek for Barron's

Shiller sees no rational reason for the sharp rise in housing prices over the past few years in many major markets.

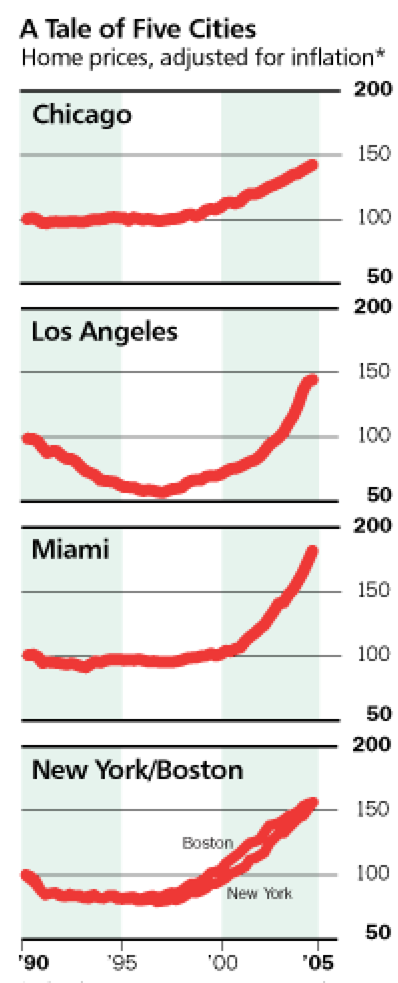
mania began in 1997 and with low mortgage rates still holding sway, the surge could persist for a while. Or it could end abruptly, as it did recently in the once-red-hot Sydney, Australia, residential market, where real (inflation-adjusted) prices rose 12.8% in 2003 before dropping 2.5% in 2004 and remaining wobbly ever since.

Housing busts, unlike bear markets on Wall Street, often start almost imperceptibly and unfold slowly. They're difficult to detect in their early phases, in part because accurate price data on comparable-home sales is hard to come by. Sure, you can look at tax records to calculate the prices fetched by two homes, each with four bedrooms and three baths and located in the same town. But determining precisely how their conditions, amenities and neighborhoods stack up isn't easy.

ADDING TO THE UNCERTAINTY: Homeowners often live in denial of market realities by listing their properties at unrealistic prices or simply taking their homes off the market to await better times.

Shiller worries that the market has become so overheated in many areas of the U.S. that any decline could pick up momentum in two to three years, when the adjustable-rate mortgages that have accounted for nearly half of all home loans in the second half of 2004 will begin to "reprice" at higher interest rates, potentially burying overly optimistic buyers sporting scant equity but hefty debt. Low-to-no-down-payment and interest-only mortgages would only add to the possible mayhem of involuntary sales if home prices were to sag, Shiller adds.

In Shiller's view, a real price decline of as much as 50% in U.S. home prices over the next decade isn't beyond the realm of possibility. Such a drop would be less catastrophic than it might seem at first blush. Like any economist, Shiller adjusts annual returns for inflation, which tends to amplify any downturn and mute upturns in nominal home prices. Thus he foresees only a 20% to 25% cumulative decline in nominal prices (which works out to about an average of 2% a year over the decade) with the loss of purchasing power from 3% annual inflation accounting for the remainder of the "real" decline. Still, that would be a crushing blow to anyone counting on rising home values to bail him out of any financial problems.



Such real declines aren't unprecedented. Los Angeles-area home prices fell over 40% in real terms between 1989 and 1997 before beginning a sharp ascent. That drop was largely attributed to job losses from the contraction of the aerospace and defense industries in Southern California in the late 'Eighties and the 'Nineties.

However, today's speculative real-estate bubble is so extreme that it wouldn't take an "exogenous" event like surging interest rates or a recession to prick it, warns Shiller. Prices could simply crash under their own weight.

Three months ago, Shiller released a heavily revised edition of *Irrational Exuberance* that includes a number of sections on the real-estate bubble and the trouble he foresees for housing.

The Yale economist has done much work over the years on the behavior and psychology of the residential real-estate market, including a number of annual surveys of current expectations of homeowners around the U.S.

In 1988, dissatisfied with the home-price data put out by both the National Association of Realtors and the federal government, he and Wellesley College economist Karl Case established a price index based on "repeat sales" (to filter out distortions from changing mixes of house sales or other problematic factors). The project led to the formation of a company called Case Shiller Weiss that later became part of Fiserv. The CSW survey captures reliable housing data from major markets throughout the U.S. that tends to closely track the best price data put out by the U.S. Office of Housing Enterprise Oversight.

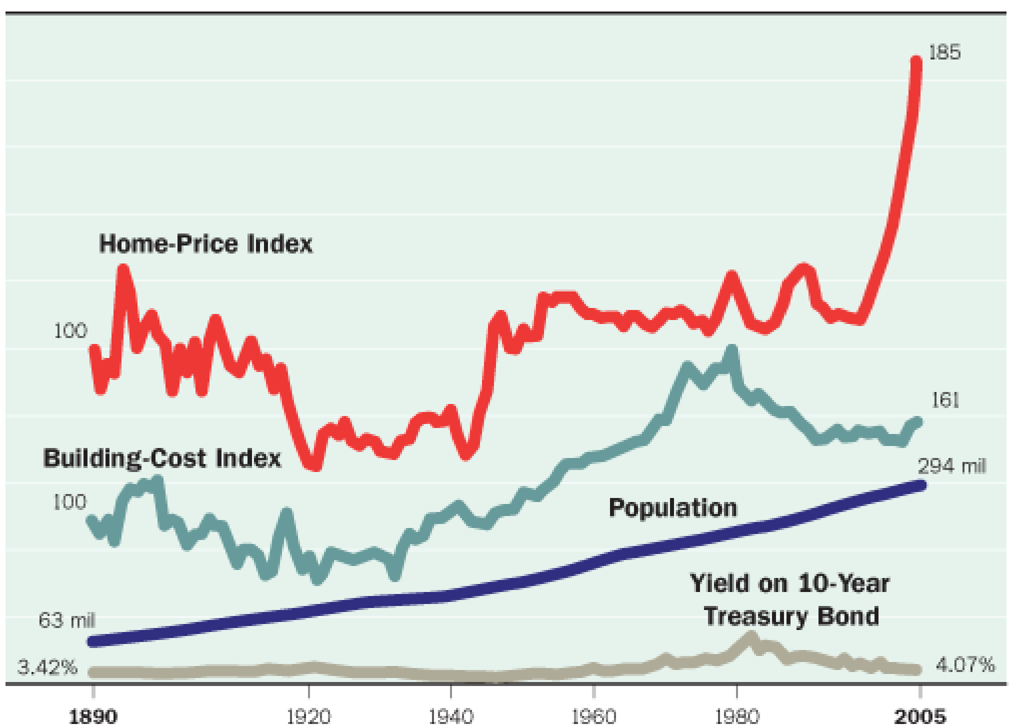
Shiller's data show a housing bubble of extraordinary dimension.

The rise in real prices since 1997 has already dwarfed the surge after World War II, when long-pent-up demand for homes overwhelmed supply for a time. And it only seems to be gathering velocity, with each year's increase topping the previous one's. Though in 1997 real U.S. home prices went up 2.1%, by 2000 the rate of increase had accelerated to 5.8%. Last year it hit a torrid 11.2%, and Shiller believes it exceeded 15% in this year's first quarter. The housing-price chart has gone nearly vertical, in seeming defiance of the gravitational drag of inflation and more subdued growth in personal income and gross domestic product.

As a market behavioralist, Shiller takes a dim view of what he calls the glib fundamental explanations offered by the housing bulls to justify home prices' moonshot.

Tracking the Trends

The charts show movements since 1890 in four key factors influencing the U.S. housing market. (Both building costs and home prices are adjusted for inflation and indexed.) In recent years, changes in home prices have far outpaced those in the three other elements.



Source: *Irrational Exuberance: Second Edition*

Perhaps the bull case is best summed up in a recently published book by David Lereah, chief economist of the National Association of Realtors. Its pithy title: *Are You Missing the Real Estate Boom? Why Home Values and Other Real Estate Investments Will Climb Through the End of the Decade -- And How to Profit From Them*. Shiller wonders whether this tome is housing's equivalent of 1999's *Dow 36000*, published just months before the stock market turned south.

Lereah asserts that the surge in home prices has far from run its course because of low inventories, modest mortgage rates that won't rise high enough or fast enough to end price expansion, the favorable demographics born by boomers and retirees, who buy second homes or downsize into opulent, smaller abodes, and strong demand from immigrants and echo boomers. Likewise, according to Lereah, technology has eased the cost and time needed to buy or sell properties. Automation of mortgage underwriting has helped immensely, as has the ability to do online research and to obtain innovative mortgage products. In addition, low-income assistance programs should continue to boost the level of U.S. home ownership. Finally, the shock of the 9/11 terrorist attacks shifted the flow of investment funds from stocks to real estate.

Shiller is skeptical of such arguments. He and a platoon of graduate students have culled housing data going back to 1890, without finding a particularly robust relationship between home prices and many of the fundamental factors cited by Lereah and other bulls.

Take population. It has expanded at a slow and steady pace since World War II, which hardly explains the latest pyrotechnics in home prices. Limitations on supply, even with the advent of more onerous zoning and land-use restrictions in some areas, doesn't explain the bubble. Prices have risen sharply even in cities that boast plenty of vacant land for development and that, in the past, have acted as demand safety-valves. And torrid condominium construction and conversion has relieved much of the supply pressures in glamour metro areas such as New York, Boston, Chicago and San Francisco.

In the past, home prices were somewhat tied to construction costs, but those days seemingly are gone. In fact, according to Shiller's data, inflation-adjusted construction costs largely have fallen since 1980.

Low mortgage rates are the most widely cited cause of housing bubbles, not only in the U.S. but in other developed countries, including the U.K., France, Spain and, formerly, Australia. Central banks, fearful of a weak global economy and the repercussions of stock-market busts, have inadvertently boosted housing prices by slashing interest rates, or so the thinking goes.

Shiller points out that central banks have cut rates many times in the past without sending prices into hyperspace.

The correlation between rates and housing prices isn't always clear. In fact, plenty of regional housing bubbles have occurred in the U.S. during periods of sky-high interest rates -- such as the 60% jump in real home prices in Los Angeles between 1975 and 1980. In addition, prices have jumped sharply in some areas just before rates stumbled. They soared in Boston in the 'Eighties (climbing 38% in 1985 alone) before going into a funk during much of the early 'Nineties, despite sharply sliding mortgage rates.

Finally Shiller contends that many of the innovations in home finance that Lereah and others laud may ultimately destroy the very housing bubble that they helped create.

Interest-only mortgages, ARMs and lax mortgage underwriting standards are putting many buyers into dwellings that they couldn't otherwise afford. That's one reason that affordability ratios of median home prices to median income in red-hot markets like San Francisco, San Diego, New York and Miami have soared to nose-bleed levels, despite cheap mortgage rates. "Prices better keep going up, or a lot of folks are going to be upside-down on their mortgages," Shiller warns, using car dealers' jargon for a motorist whose vehicle is worth less than he owes on his auto loan.

Frenzies like the housing bubble are more products of manic shifts in mass psychology than any rational response to favorable trends in market fundamentals such as rising personal income, according to Shiller. In essence, investors periodically succumb to greed and speculation fever, fired by vivid media and word-of-mouth testimony of can't-miss New Era investment opportunities. Price increases beget further gains, making investors' magical thinking seem plausible.

To Shiller, the housing bubble grew out of the same irrational exuberance that gave rise to the 1995-2000 stock mania. That would perhaps explain why most of the housing bubbles around the globe occurred in countries that also had stock bubbles. A recent study by the Bank of International Settlements of home prices in 13 industrialized countries indicated that peaks in home prices tend to trail stock-market peaks by two years or so.

Shiller theorizes that both U.S. bubbles were precipitated by such factors as increasing veneration of market capitalism, the growing respectability of speculation and conspicuous consumption, and the conviction that the Internet and other technologies augured a golden age of unparalleled prosperity.

Notes Shiller dryly: "Once stocks fell, real estate became the primary outlet for the speculative frenzy that the stock market had unleashed. Where else could plungers apply their newly acquired trading talents? The materialistic display of the big house also has become a salve to bruised egos of disappointed stock investors. These days, the only thing that comes close to real estate as a national obsession is poker."

According to Shiller, Uncle Sam played a role in the housing bubble well beyond a Fed monetary policy that generally has flooded the system with liquidity. Authorities in Australia and Great Britain issued a number of warnings of unsustainable conditions in their property markets, while U.S. officials have been mostly silent on the issue. Until a month ago, banking regulators had done little to rein in unsound mortgage lending practices. And only after a May 20 speech did Fed Chairman Alan Greenspan acknowledge that there might be some "froth" in the U.S. housing market, although he denied that a nationwide bubble exists.

'Fessing up to the existence of a problem only after it has exploded is old hat to government officials. The F.B.I.'s J. Edgar Hoover finally admitted to the existence of the Mafia late in life, after years of denying the existence of a national crime syndicate.

Greenspan is expected to step down early next year. It might be a propitious time for him to get out of Dodge. For if Shiller is right, running the Fed won't be much fun when the air goes out of the housing balloon.

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