The Campbell Real Estate Timing Letter

Separating likely probabilities from whims and pure hope

The only real estate timing advisory for Southern California investors May 15, 2008

House Prices versus Rents: No Where Near a Market Cycle Bottom

How do you determine when the rapid growth in housing prices is caused by sustainable economic factors, or when such growth is the result of an unsustainable bubble?

Here's how the Nobel Prize economist (2001) Joseph Stiglitz defined asset bubbles: "If the reason for the price being high today is only because investors believe that the selling price will be even higher tomorrow – when 'fundamental' factors do not seem to justify such a price – then a bubble exists."

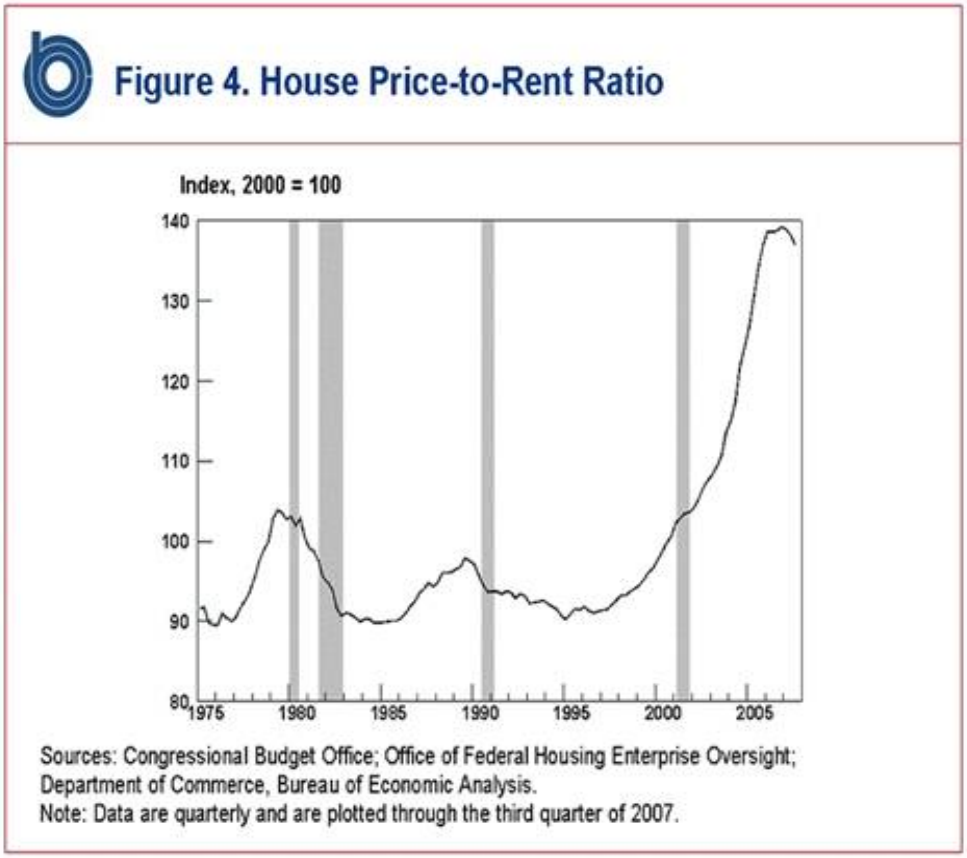
In the March 15, 2008 issue of this letter, I looked at price-to-income ratios in order to evaluate the state of housing prices – in a way that is grounded in economic fundamentals. In doing so, I was able to calculate how far U.S. housing prices were likely to fall after the collapse of the bubble in the U.S. housing market.

Another popular measure used to evaluate housing valuations is the house price-to-rent ratio. This metric is intended to reflect the relative cost of owning versus renting. When housing prices are too high relative to rents, it is logical to assume that potential home buyers will chose to rent, thus reducing the demand for houses and bringing house prices back into alignment with rent. When housing price-to-rent ratios rise to extreme levels – just as when price to income ratios rise to extreme levels – housing is said to be in a "bubble."

To make an important distinction, you must be aware that the price of an asset can be substantially different than the economic value of an asset. That's because "price" is what you pay, but "value" is what you get in return. So what factors determine the economic value of owning a house?

If we use the most widely accepted financial model for determining economic value, the value of an asset is calculated to be equal to the sum of its future payoffs discounted back to the present. To value stocks, the expected future payoffs include dividends and price appreciation. This approach can also be applied to housing – whereby if we ignore tax benefits, there are two primary economic "payoffs" that a homeowner can benefit from. First, there is the payoff that the owner receives by having a roof over his head and not having to pay rent. The second payoff is the potential capital gain that can accrue to the owner from housing price appreciation.

In this issue, I will use the house price-to-rent ratio to measure how far housing prices have deviated from their fundamental value – and based on historic patterns for this ratio, how far housing prices could fall before we see a market bottom. One look at the chart of on the following page gives us a good idea what to expect.



The above chart is a good measure of housing fundamentals – showing the historic relationship between house prices and rents. From 1975 to 2000, the price of U.S. single family home prices fluctuated from a low of 90 times average monthly rent to a high of 104 – a fairly tight range. From 2000 to 2007, however, that relatively tight range was blown completely out of the water. These, of course, were the bubble years for housing, where the ratio rose from a reading of 100 in the year 2000 to a record high (and peak reading) of 140 in the year 2007 – an incredible rise of 40%.

Prior to the year 2000, there were two complete boom-bust cycles in the previous 25 years – which look tame when compared against the latest housing market boom. During the 1970s real estate boom, for example, the house price to-rent ratio rose from a low of 90 in 1976 to a high of 104 in 1979 – a 16% increase. After that, the ratio declined back to 90 during the 1980s bust – erasing all of prior gains.

Then came the real estate boom the 1980s, which saw the house price-to-rent ratio rise to a high of 98 in 1990 – a 10% increase from the 1980s low. During the following bust, the ratio declined back to 90 in 1995 – once again erasing all prior gains.

The above chart clearly shows that from 2000 to 2007, housing prices grew faster than rents by a huge margin. If we assume the price-to-rent ratio averaged roughly 95 time average monthly rent from 1975 to 2000, we see that the 2007 peak reading of 140 rose to a level that was 47.4% greater than its previous historical norm. What implications does this have for housing prices? It suggests that if the ratio bottoms out at 90 during the current housing market bust – just like it did during the two previous busts – that ratio will have to fall by 35.7%.

Keep in mind that while price declines will bear most of the brunt of the declines in the price-rent ratio, rising rents will (or could) also bring the ratio back into alignment with their long-term historical average. For example, I read an April 2008 report by Economy.com that forecasted future rent increases for 54 different U.S. housing markets. The average rise in rents for all 54 markets was projected to be 11% over the next five years. Thus, to reach a correction of 35.7% for the house price-to-rent ratio, U.S. housing prices would need to fall by 24.7% (35.7% minus 11%).

What Drives the Housing Price-to-Rent Ratio?

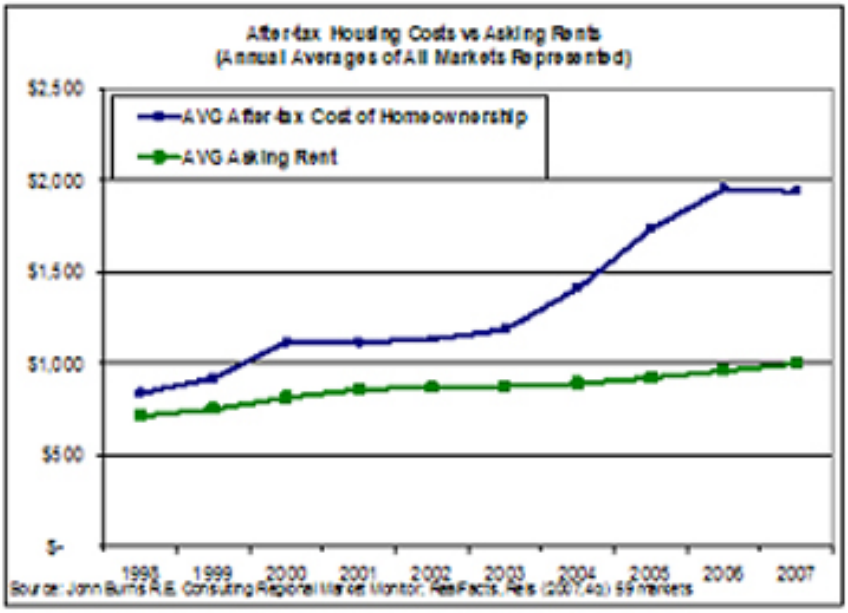
As we account for the past fluctuations in the housing price-to-rent ratio, you may wonder which of the two sources of economic payoff that I mentioned on page 1 are considered to be most important to homeowners. Are the changes in the price-rent ratio driven mainly by the desire to own and not pay rent? Or are the changes mainly driven by expectations of making money through price appreciation?

Empirical evidence clearly shows that the primary reason that people buy houses instead of paying rent is that they want to make money. You may be interested to know that this is the same reason that people buy stocks – they are looking for price appreciation first and collecting dividends second. Thus, the determining factor that explains whether the price-rent ratio rises or falls is whether people expect housing prices to rise or fall and to a much lesser degree whether the amount of rent they pay is likely to rise or fall.

Applied to local real estate markets, the implications of this finding are enormous for investors. It means that if the ratio is to return to its average level of 95, it will likely be due to falling home prices – not through rising rents.

The Cost of Owning vs. Renting

The following chart – "After-tax Housing Costs vs. Asking Rents" – is from John Burns Real Estate Consulting. It shows that on a national basis it now costs almost twice as much to buy a home as to rent – which is roughly 9 times more than the differential that existed in 1998.



In 1998, Americans were only willing to pay an average of 10% more to own a house or condo than they would to rent a similar property. By 2006 – the peak of the speculative housing craze – they were willing to pay almost 100% more. The economic preference for buying vs. renting had dramatically changed because homebuyers expected to make a huge profit when they sold – which, as shown by the chart on page 2, occurs during all real estate booms.

While national house price-to-rent averages tell us what has happened – and based on historical patterns, what is likely to happen in the future – on a broad macro-economic level, these "averages" don't tell us much at all about the price-to-rent differences that exist between individual U.S. housing markets.

The chart on the following page is from the Center for Economic and Policy Research. The date of the study was April 2008, and it compares the cost of owning and renting in 20 individual housing markets – giving you a clear idea of the extent of the bubble in various cities.

The methodology for this study uses data on median house sales prices from the 2006 American Community Survey. Calculations in the low, middle, and high cost scenarios use the monthly payment on a 30-year fixed rate mortgage at 6%, 7% and 8% interest rates respectively, for 75% of the median house price for each metropolitan area. The figure of 75% was used to take the tax-savings of homeownership into account. Property tax rates of 0.75%, 1.0%, and 1.5% were used in each scenario. The low, middle, and high cost scenarios assumed combined maintenance costs of 0.75%, 1.0%, and 1.5% of the sale price, respectively.

The data for rents came from the Dept of Housing and Urban Development, identified as "the amount that would be needed to pay for shelter plus utilities of privately owned, decent, and safe rental housing of a modest nature (non-luxury) with suitable amenities." As you can see from the "monthly rental costs" shown in the table's last column, we're talking about middle-income housing here – nothing fancy.

TABLE 1
20 City Comparison

City	Monthly ownership costs			Monthly rental costs
	Low	*Middle*	*High*	
Atlanta	$991	$1,131	$1,332	$824
Baltimore	$1,600	$1,826	$2,150	$1,013
Boston	$2,051	$2,340	$2,755	$1,353
Chicago	$1,335	$1,524	$1,794	$944
Cleveland	$767	$876	$1,031	$725
Denver	$1,274	$1,454	$1,712	$876
Detroit	$850	$970	$1,142	$805
Houston	$710	$810	$954	$852
Las Vegas	$1,575	$1,797	$2,116	$996
Los Angeles	$3,054	$3,485	$4,104	$1,300
Miami	$1,636	$1,867	$2,198	$1,035
New York	$2,415	$2,756	$3,245	$1,318
Philadelphia	$1,227	$1,400	$1,649	$932
Phoenix	$1,343	$1,532	$1,804	$862
Sacramento	$1,973	$2,251	$2,651	$982
San Diego	$2,771	$3,162	$3,724	$1,355
San Francisco	$3,637	$4,149	$4,887	$1,592
Seattle	$1,921	$2,192	$2,581	$942
Tampa	$1,008	$1,150	$1,354	$883
Washington	$2,303	$2,627	$3,094	$1,324

Source: Census Bureau, U.S. Department of Housing and Urban Development (HUD), and authors' calculations, see appendix. (**Bold** denotes a bubble market.)

In five of these markets – Atlanta, Cleveland, Detroit, Houston, and Tampa – the cost of owning and renting are more or less the same. These cities are classified as non-bubble markets, and they should theoretically experience "below average" price depreciation during the current real estate downturn.

The other 15 cities, however, are bolded to denote that they are in bubble markets. These cities experienced an extraordinary run-up in housing prices in the last 10 years that have not been matched with a comparable increase in rents. In some of these markets (New York, Los Angeles, San Francisco, San Diego, Sacramento, Seattle, and Washington DC), the cost of homeownership is double, and even close to triple, the cost of renting comparable units.

In New York, the cost of owning in the middle scenario is 109% higher than rental costs. In San Diego, it is 133% higher. In San Francisco, it costs 161% more to own than rent, and in Los Angeles, it costs 168% more.

Because prices are now falling rapidly in many of these bubble markets, homebuyers are taking a serious risk that their homes will plunge in value. This explains why sales volume has been in a steep decline: potential homebuyers are becoming less and less willing to pay these inflated costs of housing for fear of losing money. This data also explains why the willingness to "walk away" and rent is becoming a more and more compelling option for homeowners that are upside down on their mortgages.

Predicting How Far Housing Prices Will Fall

In forecasting how far housing prices will fall during this current real estate downturn, I want to revisit some excellent research that was done in January 2006 by the economists at the international banking giant HSBC – and which was previously discussed in the May 2006 issue of this Timing Letter. The purpose of that research was to determine how overvalued the U.S. housing markets had become by the 3rd Quarter of 2005, which as we now know was close to the peak of the bubble that has now burst.

What is most relevant of HSBC's 2006 research to this issue is how the Q3 2005 price-rent ratios for major U.S. cities compared to their 30-year averages. Using all the 20 cities that are listed on page 4 – plus an additional six more cities – the results of those findings are shown in the table below.

Metro area or city	P/R Ratio Q3 2005	P/R Ratio 30-year Avg.	% Correction Needed to P/R ratio
NATIONAL AVERAGE	20.7	14.0	48%
Atlanta	13.8	11.7	18%
Baltimore	20.5	12.7	62%
Boston	22.0	13.9	58%
Chicago	20.5	13.2	56%
Cleveland	14.1	12.3	14%
Denver	19.6	13.8	42%
Detroit	14.4	10.5	36%
Houston	13.5	13.6	-2%
Las Vegas	25.1	16.2	56%
Los Angeles	32.3	18.2	78%
Miami	27.3	14.1	93%
New York	30.1	18.9	60%
Philadelphia	16.4	11.3	45%
Phoenix	19.8	12.2	62%
Sacramento	28.5	16.7	71%
San Diego	38.2	21.8	75%
San Francisco	32.7	19.7	66%
Seattle	26.5	15.5	71%
Tampa	17.3	11.4	52%
Washington DC	25.3	16.1	56%
Riverside/San Bernardino	32.6	16.6	96%
Memphis	15.0	14.4	4%
Indianapolis	12.6	11.7	8%
Cincinnati	15.3	13.6	13%
Austin	12.5	11.8	6%
Dallas/Fort Worth	11.5	12.9	-11%

The analysis by HSBC shows that the national price-rent ratio for U.S. homes has averaged 14.0 for the past 30 years. This ratio is calculated by dividing the housing prices by annual rents. In Q3 2005, the ratio was 20.7, and thus required a correction of 48% to return back to its historic norm of 14.0.

In some cities, however, the ratio was far worse than the national average, and in other cities it was far better. Looking at the last column of the above table, you see that the most overvalued cities were located primarily in the coastal states – especially in California and Florida, which represents the areas where speculation was most rampant. Based on the price-rent ratio, Riverside/San Bernardino was ranked by HSBC as the most overvalued area in the United States, being 96% above its 30-year average. Miami was the second most overvalued area, with a ratio that was 93% greater than its 30-year average. With rents held constant, the average price of houses in Riverside/San Bernardino and Miami would have to fall by 48% and 46.5% respectfully to return to their normal, long-term relationship with rents.

In two cities on the list, however, the HSBC formula predicts that housing prices are slightly undervalued – and therefore should rise. Based on the price-rent ratio, housing prices are undervalued in Dallas/Fort Worth by 5.5% and in Houston by 1%. In four other cities – Memphis, Austin, Cleveland, and Indianapolis – prices are only slightly overvalued – and therefore should be somewhat insulated from any significant price drops.

The big question is whether housing prices will merely drop to the point where the price-rent ratio returns to its historic 30-year norms – and motivates families to buy again – or whether potential homebuyers will still be so terrified of losing money that prices will overshoot to the downside before new buyers will feel safe enough to enter the market.

Which Way for Rents – Up or Down?

Even though jobs and incomes are now influenced by the global economy, housing and rents are still heavily tied to local economic conditions. But a large number of factors determine whether rents go up or down – and that's why we're currently seeing rents rising in some markets and falling in others.

According to data from Investment Instruments Corporation – and as seen in the table to the right, median apartment rents for 12 metropolitan areas (from Q1 2007 to Q1 2008) have changed dramatically in some markets, dropping by up to 9% in one market – Phoenix – and rising as much as 14.6% in another – San Francisco.

Rent ONE-YEAR CHANGE

Median rents for the first quarters of 2007 and 2008, with the percentage change in valued for 12 metro areas.

Area	2007	2008	Change
Atlanta	$1,007	$986	-2.1%
Austin	$936	$907	-3.0%
Boston	$1,593	$1,645	3.3%
Chicago	$1,328	$1,355	2.0%
Las Vegas	$1,053	$1,056	0.2%
Los Angeles	$1,638	$1,699	3.8%
Miami	$1,411	$1,368	-3.0%
New York	$1,606	$1,751	9.0%
Phoenix	$1,035	$939	-9.3%
San Francisco	$1,579	$1,810	14.6%
Seattle	$1,098	$1,211	10.3%
Washington, DC	$1,608	$1,687	4.9%
All metros	$1,324	$1,368	3.3%

The following is a list the supply and demand factors which will influence the rise and fall of today's rents in different cities:

1. Overbuilding. Phoenix (and also Miami) built too many dwellings in relation to the number of people who actually want to live there. San Francisco, on the other hand, did not experience an equivalent building boom – and the now the number of people who want to live there exceed the supply of housing.
2. Foreclosures. Due to people getting kicked out of their homes because of foreclosures, rents are rising in many markets. To make matters worse, a lot of lenders are holding on to these 100's of thousands of foreclosed properties – not choosing to either sell or rent them (yet).
3. Jobs and Incomes – which are tied to both the local and global economy. During a recession, people who lose their jobs will be forced to move away or double up. Young people in their 20s, who are the biggest casualties of job loss during a recession, will move back home. Vacancies will eventually force rents down.

Be aware that rents do go down during recessions. After the dot.com bust in 2000, the Mercury news reported that apartment rents in Silicon Valley dropped for four straight years. Average rents were $1,758 in 2000 and fell to $1,282 in 2004 – a decline of 27%. Rents have risen to $1,660 in 2008. So eight years later, rents in Silicon Valley are still down from the 2000 peak, even though the area has experienced a boom in their economy in recent years.

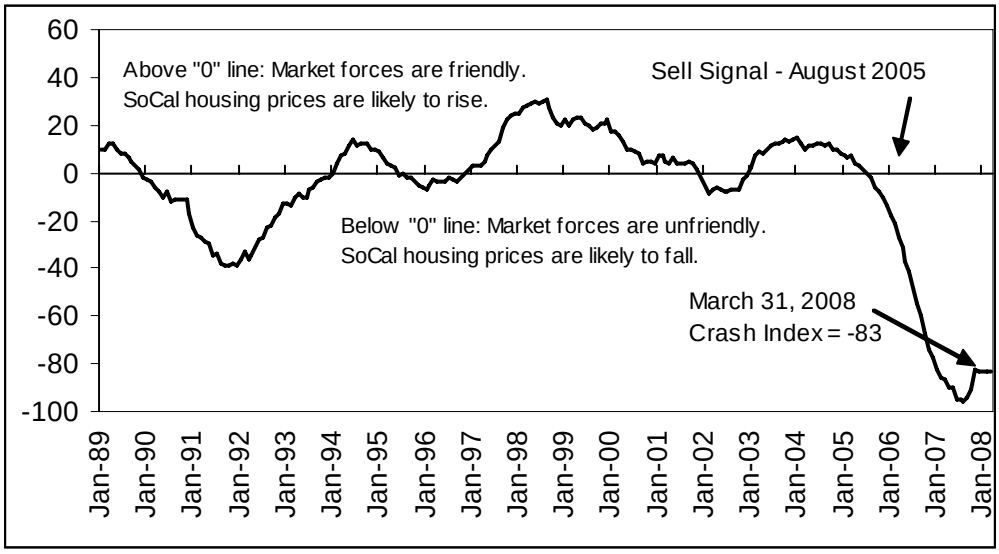
What happened in Silicon Valley can happen anywhere. With the average American strapped by record high levels of debt, falling real "inflation-adjusted" incomes, and a rising cost of living (food, energy, medical, etc.), I would expect today's recessionary conditions to put downward pressure on rents in most U.S. cities.

Based on the price-rent ratio for U.S. housing market, we now know what cities are most vulnerable to price declines – and what cities are not. Let's now take a look at the Southern California housing market, and find out what the data is telling us about the future direction of housing prices.

Real Estate Crash Index

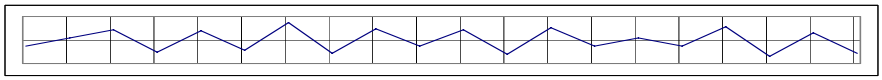
The Real Estate Crash Index gave us a -83 reading as of March 31, 2008. This forward looking indicator tells us that Southern California housing prices are likely to fall for at least the next 3 to 6 months. A "sell signal" was flashed in August 2005, when the "0" line was crossed to the downside.

Currently, four Vital Sign indicators are in trends that are unfriendly to price appreciation, and only one indicator (interest rates) is in a friendly trend.



Vital Sign Readings

SAN DIEGO VITAL SIGNS

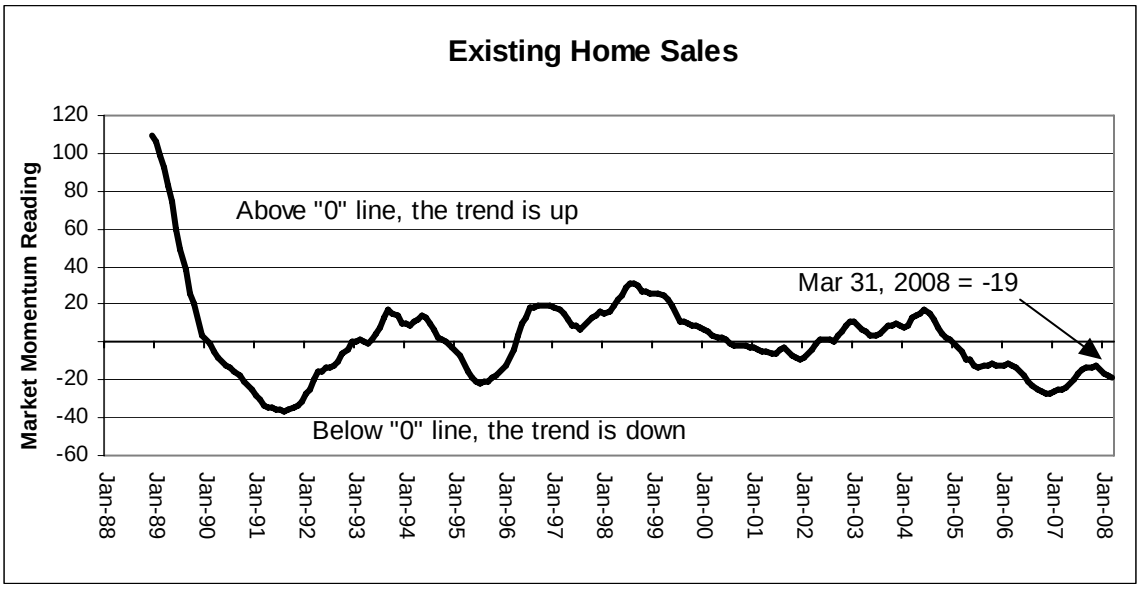


Vital Sign Indicator	Month-End			Market Momentum Reading
	Jan 08	Feb 08	Mar 08	March 31, 2008
Existing Home Sales	1,438	1,624	1,789	-19
New Home Building Permits	318	415	193	-44
Notice of Defaults	3,299	3,212	3,284	118
Foreclosure Sales	1,4615	1,398	1,161	246
30-Yr Fixed Mortgage Rates	5.76%	5.92%	5.97%	-2

Sources: DataQuick Information Svcs, C.I.R.B., S.D. Recorder's Office, Federal Reserve Board

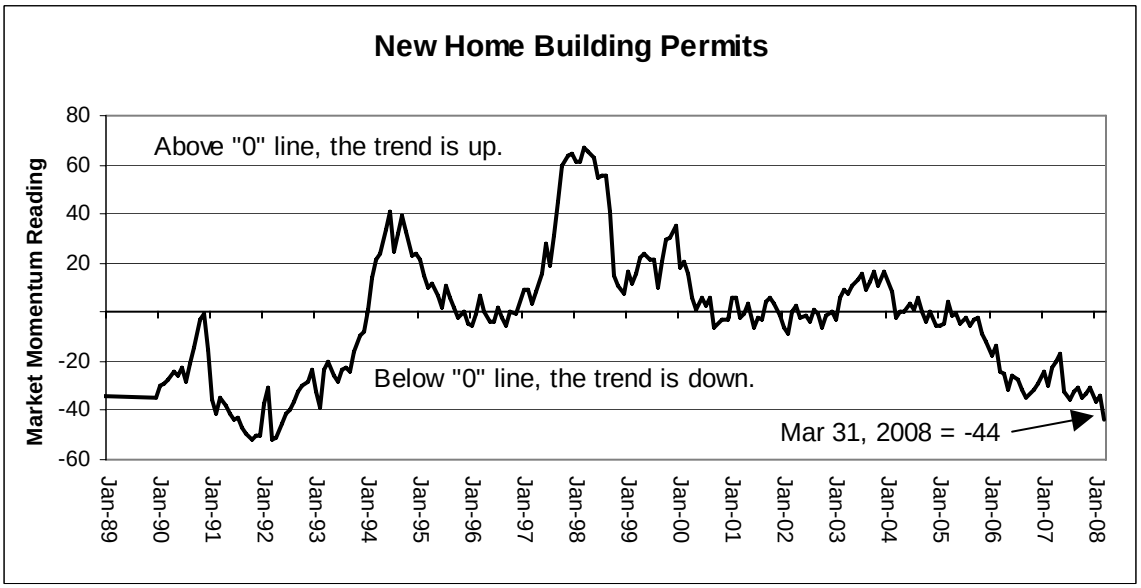
Editor's note: While my trend indicators are based solely on statistical data derived from the San Diego real estate market, the trend signals they send have historically worked with equally good accuracy for the Los Angeles, Orange County, and many/most other California real estate markets. Thus, I often use the words "Southern California" and "California real estate markets" interchangeably.

Vital Sign #1: Existing Home Sales



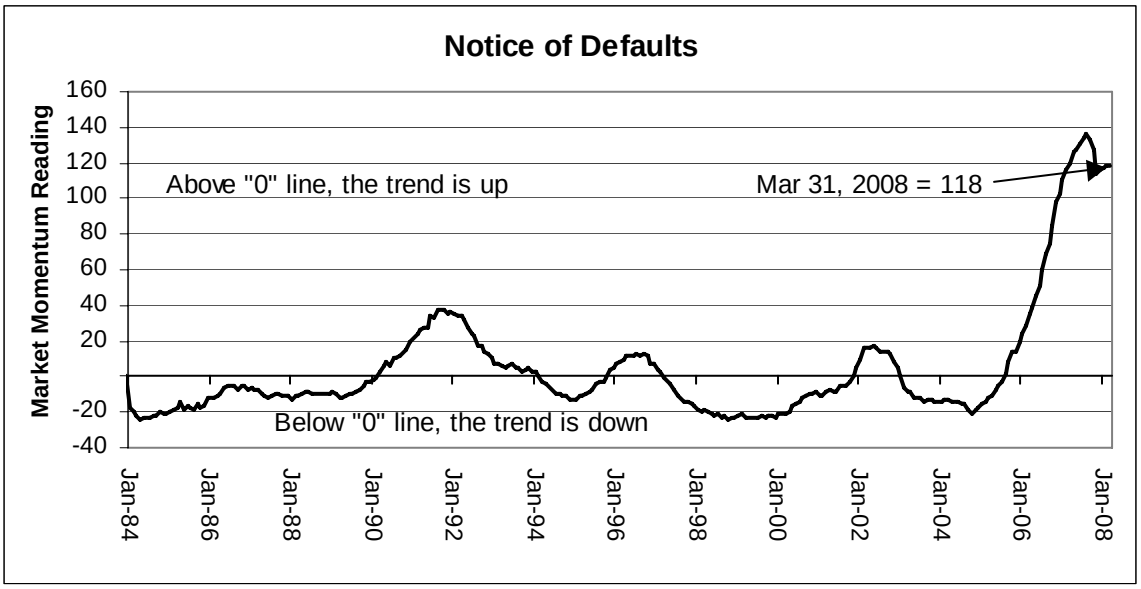
After hitting a five-year peak of +17 in June 04, the Market Momentum readings for Existing Home Sales dropped below the "0" line in February 2005 and have stayed there ever since. This is a signal that the trend is down. There were 1,789 homes sales in March 2008, giving us a trend reading of –19. The number of home sales in Southern California housing is decelerating. It has been statistically proven that Existing Home Sales are an excellent leading indicator for predicting the future direction of housing prices. The 12-month moving average (MA) was 2,037 in March 2008, the lowest reading since January 1996 (1,989) – which, according to the December 1996 "buy signal" generated by the Real Estate Crash Index, was close to the bottom of the l990s real estate down cycle. During the last upcycle, the peak reading for the 12-month MA was 4,221 in June 2004.

Vital Sign #2: New Home Building Permits



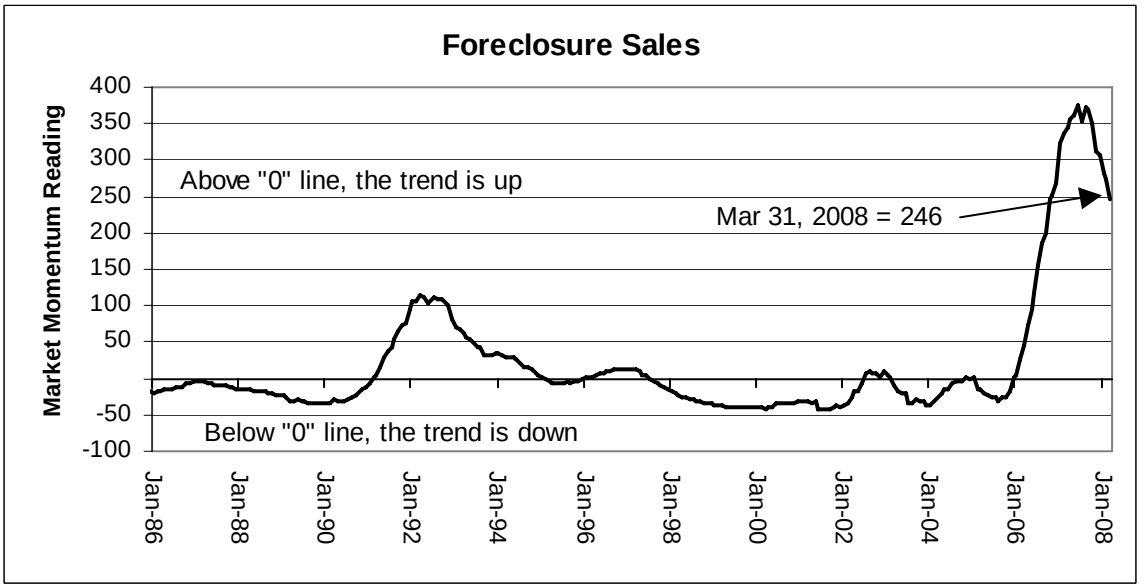
There were only 198 New Home Building Permits pulled in March 2008, the lowest monthly total ever since I started compiling this data in 1988. This produced a Market Momentum reading of –44. New home building activity is rapidly decelerating, a negative trend for housing prices and a good leading indicator as to what will be the future strength of the SoCal economy. The 12-month moving average (MA) was 486 in March 2008, the lowest reading since January 1994 (474). The March 2008 MA is currently 69% lower than its most recent peak reading of January 2004 (1,556) – which was when the SoCal real estate market was booming.

Vital Sign #3: Notices of Default



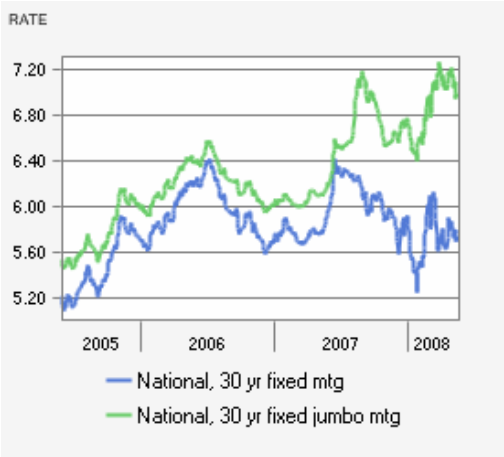
There were 3,284 Notice of Defaults in March 2008, producing a Market Momentum reading of +118. This tells us that mortgage defaults are in a strong uptrend, which is a negative sign for both the San Diego economy and its housing market. The 12-month moving average was 2,314 in March 2008. This is the highest 12-month moving average reading ever, surpassing the prior peak of November 1993 (1,044) by 122% – which marked a point in time when the SoCal real estate market was only half way through the last down cycle that lasted for 6 years.

Vital Sign #4: Foreclosure Sales



There were 1,161 foreclosure sales in March 2008, producing a Market Momentum reading of +248. The 12-month moving average for foreclosure sales was 922 in March 2008, and has been moving steadily higher since hitting a 23-year record low set in August 2005 (37). The March 2008 12-month moving average was the highest reading ever. The previous high was 503, recorded in February 1997, which was near the bottom of the last down cycle that, according to the Real Estate Crash Index, ended in December 1996.

Vital Sign #5: Interest Rates



Two opposing market forces are currently pulling on the direction of interest rates. The slowing U.S. economy is bullish for lower interest rates, while the rising rate of inflation and need of the U.S. government to finance an increasing budget deficit in the face of falling tax revenues is bearish. The Fed may have ended its rate cut cycle, that may be one more reason interest rates could be headed up. So far, and as seen on the chart to the right, the trend for 30-year fixed rate mortgages has been sideways. However, rates for jumbo mortgages – loans that are greater than $417,000 – have trended higher in the last 12 months in order to compensate for the increased risks of making loans in high-priced housing markets.

Final Words: No Near-Term End to the Housing Bust

When asset bubbles burst, prices tend to return to pre-bubble levels. This means a return to 2002 housing prices, and possibly lower depending on the severity of the U.S. recession that has only just begun.

Every week I hear or read about someone who is calling for a bottom to the housing market. Such comments seem disconnected from reality considering the latest trend readings on home prices. According to the most current data available from the Case-Shiller Indexes, home prices for their 20-city composite fell by 12.7% in the last 12 months ending February 2008 – which represents a record year-to-year decline. Furthermore, the decline has accelerated almost every month since the peak reading of July 2006. If we look at price changes for the last three months, the 20-City Composite fell at an annualized rate of 27.6%.

Of U.S. homeowners who bought when prices peaked in 2006, Zillow.com says that one out of every two (51.6%) now owes more on their mortgage than their home is currently worth. For those who purchased in 2005 and 2007, nearly 42% and 45% are now facing negative equity. In Los Angeles, the situation is worse: a little over 70% of all 2006 homebuyers now have negative equity.

The price of houses compared with rents is extremely high by historical standards. And with an economic recession now bearing down on 10's of millions of American homeowners who are currently upside down on their mortgages, the potential for a surge of "walk-aways", rampant foreclosures and steep price declines is a risk potential buyers cannot ignore. While waiting for housing prices to stabilize and for the trend to reverse, my recommendation remains unchanged – so stay in cash for the time being. Why buy something today when odds are good that you can buy it cheaper tomorrow?

To all my valued readers, best wishes until next issue.

Robert M. Campbell
(858) 481-3235

PS: My annual real estate timing seminar will be held on June 21, 2008. It will at the Del Mar Hilton, going from 9:00 AM to 1:00 PM. The cost is $120.00, and it includes a FREE one-year subscription to The Campbell Real Estate Timing Letter. The topic will be: ***Timing the Real Estate Market – How to Prepare for Next Great Buying Opportunity***. To register, email me at Robert@RealEstateTiming.com.

As a special feature this year, I will be launching Emerging Housing Markets – where my new timing model will help to identify the best time to buy in 17 major U.S. housing markets. This is a must see!

The Campbell Real Estate Timing Letter is published bi-monthly by Robert Campbell. All subscription inquiries should be directed to: 3525 Del Mar Heights Road, #634, San Diego, CA 92130. Telephone number is (858) 481-3235.
Website: www. SanDiegoRealEstateReport.com
Subscription rates: $120.00 per year (6 issues). Individual issues are $25.00 each.
How to read the Vital Sign charts: All charts use the statistical tool called "momentum analysis" to determine trend changes in the marketplace. Trend changes are signaled when the "0" line is crossed. When the market momentum reading is above the "0" line, it means the trend is upward. When the market momentum reading is below the "0" line, it means the trend is downward. Consult the *book Timing the Real Estate Market* for a complete understanding of these charts, how to construct them, and how to interpret them.