

Nightmare on Main Street

IN MY DECEMBER 2002 COLUMN, "THE Economy's Linchpin," I predicted that U.S. real estate prices would rise more strongly than expected, helping to drive economic growth. However, I also offered readers three signals that would cause me to worry about this critical sector: "If housing is a bubble, it will not likely burst until the economy recovers, everyone becomes complacent and the Fed's interest rate policy shifts. At the end of October [2002], it does not even look like a bubble to me."

More than a year and a half after writing these words, I believe that all three of these signals have emerged in a manner with ominous global implications. Although I'm going to focus on the U.S. market in this column, the fact is that much of the western world, including countries like the United Kingdom, Australia, the Netherlands and Denmark, are seeing a similar confluence of events. In addition, exporting economies like Japan, Taiwan, Korea and China, as well as the semiconductor industry itself, would all be negatively impacted by a substantial deterioration in the U.S. consumer's financial health and ability to spend, which a housing bear market would portend.

THE FOUR HORSEMEN

As we enter the second half of the year, we can see that the economy has recovered, the Fed has shifted from a loosening to a tightening bias, and there is much less concern about housing than there was in 2002. Needless to say, evaluating complacency is trickier than pointing out that the economy is growing and the Fed is tightening. But many factors are signaling loudly and clearly that complacency is high and getting higher; surveys show investors are expecting home prices to rise much more in the future than the historical average, and there is rapidly-growing interest in second homes and income properties as well as the use of more leverage in the purchase of such properties.

As was the case with tech stocks in the late 1990s, people are increasingly of the opinion that the biggest risk in the real estate market is being out of it, as prices continue to march higher and most find the idea of a long-term decline unimaginable. There are still a handful of people warning about a real-estate bubble, but again like the tech stock bubble before, their numbers are dropping even as the risk level rises. However, don't count me among the few who think an apocalypse is imminent. Even though three of my horsemen are riding – economic recovery, tighter monetary policy and investor complacency – I have a fourth that goes by

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the name of inflation, which shows signs of stirring but has yet to really get going. It will.

NATURE OF THE BEAST

Although I think risk levels in residential real estate are now very high, I also think that prices will go even higher and prove most of the experts (who think prices will only rise moderately at best in the near future) wrong again. I expect a top as early as 2005 or as late as 2007 but most likely in 2006. Why, if I expect prices to rise more than people expect in the near term, do I think we are in a dangerous bubble? Our economic policy has too much stimulus – interest rates that are much too low, government spending that is much too high and a currency that is dependent on foreign capital inflows. All that stimulus has to go somewhere, and I think a lot of it will keep going into real estate. But the inevitable result of too much stimulus is our fourth horseman – old-fashioned, growth-stifling inflation.

So what happens when the Fed is forced to tighten hard to fight its old nemesis and triggers a recession typical of the type we haven't seen in quite a while, with rising consumer prices and significant job loss? What happens when mortgage financing gets very expensive? What happens when the payments surge on those record amounts of interest-rate sensitive debt, especially those widely-popular adjustable-rate mortgages? What happens when the baby boomers that haven't saved enough for retirement see their real-estate wealth evaporate? What happens in a bubble when there are suddenly a lot more sellers than buyers?

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