

7-17-05

Bubble? What bubble?

By Richard Stanley

Everyone asks me the same question: “Is the real estate bubble ready to burst?” First, that there is such a thing as a “bubble” is in dispute. Some folks believe that our recent real estate appreciation (“the bubble”) is a sustainable reality thanks to increased population pressure on the most blessed-by-man-and-nature place on Earth. Others point out that real estate moves in cycles and that straight up, for years, is not a cycle. Until I get a crystal ball with a view of the future, my short answer to the bubble question is, “I don’t know.” None of us will really know if we were in a bubble until after the fact. Here’s why:

Many buyers, especially first-time buyers, are eager to get out of their rented apartments and into condos and houses. Low interest rates, which are still extremely low despite recent upward adjustments to the prime by the Federal Reserve Board, continue to be especially attractive to the lower-price range of homebuyers. Bear in mind that current rates as I write this column are still under six percent for a conforming loan (under about \$360,000). At best, in the 1980s, rates were about nine percent, and buyers in the real estate boom of 1988-‘89 were very happy with double digit interest rates. Interest rates on purchase money, therefore, continue to be a comparative bargain not seen since the 1960s. The ongoing strength of the low-end of the real estate market is why condos, for example, are appreciating far faster than single family homes—a never before seen phenomenon—and why the low-priced “starter home” is extinct. The median price of a home in Los Feliz is well over \$1 million—and the size of this median home is shrinking.

Another impetus fueling the local real estate market is that many younger buyers are receiving significant help from their wealthier parents in the form of loans, gifts or inheritances. This trend will continue for some time, as the Baby Boomers and Gen X-ers receive unprecedented inheritances from their parents. The problem for them, and others, is what to do with excess wealth. The answer of yore was to “diversify” by putting some money into equities and/or bonds, some money into real estate; some money into other investments such as art or collectibles and to keep some in cash, “just in case”. Today’s conventional wisdom is that equities, i.e., the stock market, are very soft—and due to get softer, as foreign markets and economies get stronger and compete for investors and also as the Baby Boomers begin to liquidate their equities to fund their retirements. As the stock market has waned in popularity as a store of excess wealth, real estate has enjoyed unprecedented increased popularity. With this popularity has come more buyer competition and higher prices.

Another factor fueling upward price pressure is the not-to-be-under-appreciated psychological appeal of owning one’s own home in a time of world-wide political anxiety. Speculators are also helping to inflate the prices of local real estate, as they help to foment the “bidding wars” on many properties. The more offers on a property, the higher the price.

Our local economy, more than ever before in recent times, is hitched to the entertainment industry. As this economic engine goes, so goes our local economy. Many younger buyers are well-heeled, thanks to a relatively long period of economic stability in the entertainment industry. Our local real estate inventory of classic vintage character and sleek Modernist homes is highly-desired by these buyers. With its central location, our elegant and eclectic neighborhood is preferred by more and more buyers who will not commute long distances on ever-more-congested freeways.

Over the last several years, the inventory of houses for sale has shrunk. Homeowners of longstanding are reluctant to sell if the move yields marginal benefit and significant increases in their monthly overhead—especially in property taxes. Many owners re-financed some time ago and are quite comfortable with lower monthly payments. Others remodeled their homes with cash-out re-financing and no longer feel the urge to move. The effect, of course, with fewer and fewer homes for sale and a steady stream of buyers, is to push prices up, and up.

So what will cause a change in this booming status quo—or “bubble”? Several factors could force change:

- At some point interest rates could rise to a point where they will have a dampening effect upon the market as buyers’ purchasing power declines, i.e., buyers will pre-qualify for lower and lower loan amounts. Lenders will also discontinue the “easy money” loans such as no-downpayment and negative amortization loans, as these products become more and more risky. This trend is already forming. Watch the first-time buyer and condo markets here—they will soften.
- The local economy could hit a bump or worse. If the entertainment industry closes down due to a strike, or production moves out of town due to favorable exchange rates abroad or because Hollywood feels foreign travel is safe enough again, the local real estate economy will chill—especially the high-end (and discretionary) estate market.
- The national economy slides or crashes. This event could set up a chain reaction of nationwide defaults and foreclosures that will affect even our local real estate market where 20 percent or more downpayments are the norm. Nationally, homebuyers have taken to easy money loans in a big way. One economic hiccup though, and these buyers will walk away from real estate in which they have little or nothing at stake. Locally, watch the sales of properties owned by speculators and others who must sell—these owners will be the first to offer deep price reductions.
- The stock market recovers. If Wall Street wins back the favor of its customers, investment capital could stream out of the real estate market, as investors’ anxiety with an “over-ripe” real estate market will lead them to a perceived “next big thing” in equities. Speculators will be fewer; multiple offers will be rare; prices will stabilize—or even decline—imagine!
- The war on terror comes to Los Angeles. This event is the proverbial 300-pound gorilla in the room. Crystal balls will work as well as anything else in this scenario.