HOUSING BUBBLE: REALITY AND SOLUTIONS

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But what about the presence of a housing bubble, especially in the coastal regions and states showing red-hot price appreciation rates? **Table A** shows the top 20 metro areas that are on fire. Note that all of them have shown 20%+ gains in just the past year, and they all belong to just three states--Florida, California and Nevada. These price gains seem absurd at first glance. **Figure A** shows, common sense can also be misleading. This graph shows the home-price appreciation rate plotted against income growth for all the US states over the last 14 years. The red zone is the quadrant where income growth lags home-price appreciation by a wide margin. I expected to see the aforementioned three states in the red zone. But surprises never cease. New York and Minne-

Table A

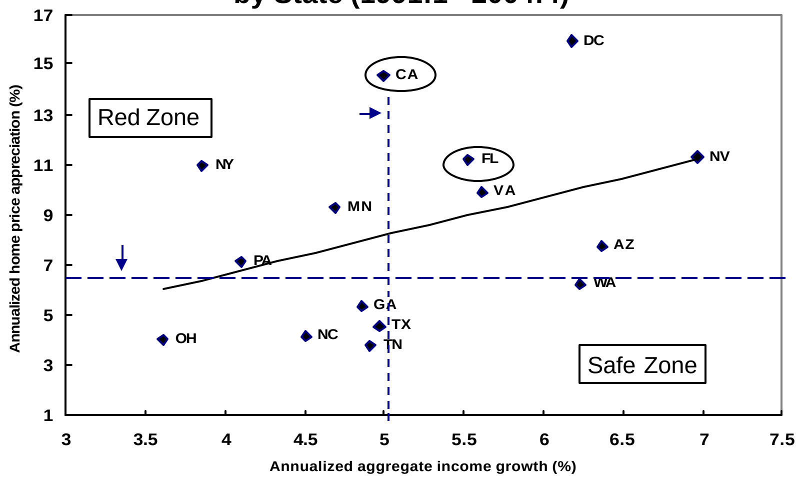
TOP 20 MSAs with HIGHEST House Price Appreciation

MSA	1-Year	1-Qtr	5-Year
1. Bakersfield, CA	33.67	5.52	101.61
2. Las Vegas-Paradise, NV	33.25	2.88	89.06
3. Reno-Sparks, NV	31.78	4.39	85.2
4. Visalia-Porterville, CA	31.6	6.18	77.27
5. Palm Bay-Melbourne-Titusville, FL	31.21	7.72	98.4
6. Salinas, CA	30.94	4.9	117
7. Riverside-San Bernardino-Ontario, CA	28.72	3.85	116.38
8. Stockton, CA	27.71	5.39	110.69
9. Merced, CA	27.45	5.77	118.45
10. Fresno, CA	26.89	5.04	111.23
11. Santa Barbara-Santa Maria-Goleta, CA	26.75	3.52	121.77
12. Yuba City, CA	26.04	4.52	121.96
13. Port St. Lucie-Fort Pierce, FL	26.03	5.5	109.35
14. Sacramento-Arden-Arcade-Roseville, CA	25.84	4.1	112.53
15. West Palm Beach-Boca Raton-Boynton Beach, FL	25.82	5.55	102.17
16. Modesto, CA	25.64	4.57	117.67
17. Los Angeles-Long Beach-Glendale, CA	25.55	3.36	105.52
18. Sarasota-Bradenton-Venice, FL	25.48	5.96	89.39
19. San Diego-Carlsbad-San Marcos, CA	25.11	3.13	117.72
20. Santa Ana-Anaheim-Irvine, CA	24.47	2.94	106.97

Source: OFHEO Report, 1st quarter 2005

Figure A

Home Price Appreciation and Aggregate Income Growth by State (1991:1 - 2004:4)



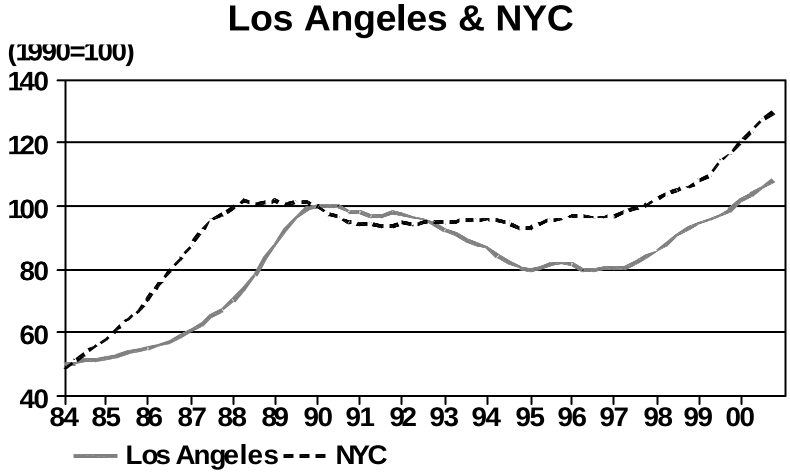
Source: EFC Calculations

sota are in the red zone, whereas California falls on the border and Florida is far away from it! This proves the point of a theoretical paper, also echoed by Greenspan in his speech in 1999, that it's difficult to statistically prove that there's a bubble from a policy-maker's perspective. It's foolish of me to even try this exercise.

We definitely have a home-affordability problem in coastal areas and a few key inland markets such as Las Vegas and Phoenix. As long as foreigners covet a piece of U.S. property in lieu of us consuming their goods, this side-effect of our consumption binge will continue. Why, you ask? To pay for the trade deficit resulting from excess consumption, one has to sell assets to the lender, and they interestingly can be of any type. Only for poor, unfortunate, emerging economies is the range of liquid assets limited to hard US currency. That takes care of the demand side from the preference perspective to quite an extent for these coastal markets. On the financing side, the judgment day for option ARM loans, interest only mortgages, and parents helping grown-up kids buy their first home by using their accumulated home-equity as a down payment--natural tools to combat the affordability problem by unfortunate locals in these states--is not due for another five years or so. This is the typical profile of these types of loans. A lot can happen on the positive side in between. Even if a correction happens before these five years are over, I have a chart that shows what home owners can expect. All they have to do is wait out about five years before their property values (of an average house) regain their lost ground. **Figure B** displays from the aftermath of bubbles in New York and Los Angeles.

Figure B

10-Year Real Estate Cycles
Los Angeles & NYC



Source: EFC Calculations

This graph, however, motivates a very pertinent query. What was the reason behind the popping of these real estate bubbles? It couldn't have been a reduced desire on the part of foreigners to buy US assets as this reasoning would have precluded the steady increase in trade deficits experienced in the last two decades. As it turns out, the culprit always is a regional shock to the manufacturing employment base. When the Berlin Wall came down in 1989, the peace dividend arrived in California in the form of quarter million job losses in the aerospace industry in just under two years! Yes, that figure is correct, and was a massive shock to a single industry's few big firms located within ten miles of each other. As a young grad student at UCLA I was there first hand to witness the deep misery in the lovely city of Angels. The same can be said of home price declines in Houston (caused by the oil crash of 1985), Boston (three big firms in the mini-computer industry with simultaneous layoffs in 1988) and New York City (massive layoffs in response to the stock-market crash in October 1987).

Thus, the common thread is a massive external shock to a premier, well-paying job provider. It always starts at the upper end of the employment scale. It then gets magnified due to other external factors such as a recession caused by an oil shock and coupled with high interest rates, as the FED is often fighting an inflation war at the same time. I don't see a scenario such as this in the near future