THE COMING CRASH IN THE HOUSING MARKET

10 THINGS YOU CAN DO NOW TO PROTECT YOUR MOST VALUABLE INVESTMENT

JOHN R. TALBOTT

The Coming Crash in the Housing Market

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McGraw-Hill
New York Chicago San Francisco Lisbon
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7 8 9 0 DOC/DOC 0 9 8 7 6 5

ISBN 0-07-142220-X

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Library of Congress Cataloging-in-Publication Data

Talbott, John, 1955-
The coming crash in the housing market : 10 things you can do now to protect your most valuable investment / by John Talbott.
p. cm.
Includes bibliographical references.
ISBN 0-07-142220-X (hardcover : alk. paper)
1. Housing—Prices—United States. I. Title.
HD7293.T36 2003
333.33'82'0973—dc21
2003002513

To my parents, my brother and sisters,
my teachers, and my friends,
who instilled in me the desire to know why,
even regarding questions that already seemed answered

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Preface

This book takes a different perspective than most books about real estate. First, it concerns itself with residential real estate, not office or commercial space. Much of the study of real estate concerns commercial real estate, as big corporations are the typical clients of most real estate advisory and consulting firms. Here the focus will be on the family home, specifically single-family houses and condominium apartments.

Second, most books that even address residential real estate look at it from the perspective of a real estate investor, someone who is looking to buy income-producing properties for investment potential. While this book will be very useful to such an investor, individual family homeowners and prospective homeowners—people just like you—are the primary audience. This book shows that it would be helpful for homeowners to start thinking more like investors, but we do not assume any special knowledge of finance or economics by readers in order to benefit from this book. While I make liberal use of charts in the book, the reader need not recognize any greater truth from them other than that a straight line up indicates a strong positive relationship.

It is really quite incredible that this book has not already been written. The average American homeowner has more equity capital invested in his or her home at current market prices than he or she does in his or her entire stock and bond portfolio. And yet when you tour the local bookstore, you will find thousands of books on portfolio investment strategy but very few, if any, that look at your home as a financial investment requiring active management. Sure, there are books on how to physically maintain and improve your property, a great growth opportu-

nity for Home Depot and Lowe's. But how many books have you seen that attempt to explain what the value of your house is, what factors determine that value, what risks you face as a homeowner, and what you can do to preserve that value in an uncertain future?

Whenever market prices of anything trend upward for any significant period of time, there is a tendency in the popular media to talk about a bubble, the implication being not only that the market price is not stable but that it is in for an eventual popping. The problem with this type of analysis, of course, is that not all bubbles burst. Some growth trends that had all the makings of a bubble early on, continued to grow up to be very strong, stable companies. Ford Motor, after introducing the Model T, and Microsoft, more recently, come to mind.

In deciding whether the current housing market is due for a major correction, the challenge is determining whether the participants are acting irrationally or there is a systemic problem such that market forces cannot act to assure that overpricing does not occur. In fact here the supposed experts are quick to blame fallible humans for acting irrationally in overpaying for their homes. It is an easy argument to make and a difficult one to refute, in as much as we all know one or two irrational humans. However, this book argues that individual buyers and sellers can act irrationally in the housing market without making the entire pricing system irrational.

Moreover, this book attempts to show that individuals and companies involved in the housing market can each act rationally and in their own self-interest, yet overvalued home prices can still result. As we will see, this is because the housing market as it is structured today is not a true economic market, and therefore prices can be enormously distorted relative to available information.

Finally, the book would not be complete if it did not offer some advice as to what homeowners can do to protect themselves from an impending downturn in housing prices. This is not as easy as it might sound, as I am sure there are few readers, regardless of how convincing they find our arguments, who will be ready to tell the spouse and kids that they just read a great new book, so it's time to pack up the Chevy and move into a rental apartment. Our challenge is to find other alternatives for the faint of heart that will protect you without so disturbing your family and home.

I hope you find the book informative. People who write such books are sometimes criticized for scaring people or partly contributing to a crash. If I am right, this book is not the problem; it is the solution. The problem is a housing market system in desperate need of reform, reform that should occur now before the situation gets worse.

I would like to thank my publisher, McGraw-Hill, who recognized the serious and timely nature of this text and set a modern-day record in getting this book into print in less than three months. I would specifically like to thank Jeffrey Krames, my editor, and Laura Libretti, both of McGraw-Hill, who were both wonderful to work with and to which this book owes its life.

I would also like to thank my family and friends. My parents, who never said I was overreaching when I talked about my goals while growing up, and my brother and sisters, who often thought I was overreaching but kept it to themselves. I could not have attempted such a task without my friends at UCLA's Anderson School of Management—Dick Roll, my coauthor on our academic papers and my biggest supporter; Ed Leamer, head of the UCLA Forecast and an important contributor to my knowledge of home prices; and Bob Geske, Bhagwan Chowdhry, Robert Spich, Al Osbourne, and Dean Willison for their overall support and encouragement. Their agreement with my thesis is neither expressed nor implied, but my appreciation and thanks to them are both expressed and implied.

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Introduction

I have a friend named Frank, who is single, 33 years old, and lives in San Diego, California. (While Frank is a hypothetical person, the incidents described here are drawn from those of a very real person and his actual experiences in recently refinancing his home.) About two years ago, Frank tired of writing rent checks to his landlord and decided to buy a condominium apartment. He paid $195,000 for a two-bedroom apartment with 840 square feet, about 5 minutes from downtown San Diego and 10 minutes from the ocean. I use the word *paid,* but actually, he put up only $4000 of his own money; the rest he borrowed from the bank in the form of a first mortgage. He was a little nervous at the time because two to three years previously similar units in the complex had sold for $140,000.

Last month, Frank decided to refinance his mortgage in order to consolidate his debts and save money, given that mortgage rates had dropped to 6 percent. A mortgage banker handled all the paperwork and the negotiations with the banks. Based on what similar condominiums were selling for in the neighborhood, the mortgage banker was able to find an appraiser who said Frank's unit was now worth $300,000. The banker was able to structure only $240,000 of the loan as a mortgage (because it had to be less than 80 percent of the appraised value to qualify for the attractive rate), but he added an additional $15,000 as a straight bank loan payable over 10 years. Frank ended up qualifying for and borrowing $255,000. He used this money to pay off his old mortgage. There was enough left over for Frank to pay off all of his student loans, all of his credit card debt, and the car loan of $35,000 on his Toyota SUV. One

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of the risks of such a consolidating loan is that it frees up Frank's credit cards for even bigger borrowings in the future. Although Frank's total debt went up, thanks to lower interest rates and making longer-term loan commitments, Frank was able to lower his overall monthly payments, including property taxes and condo-association fees.

Now, Frank is not a wealthy man. He is one of the good people out there who when given the opportunity to make the big bucks by selling out his soul, decided instead to become a high school teacher. In San Diego, as in the rest of the United States, there is not a lot of money in teaching, especially when one is starting out like Frank. Frank's teaching salary is about $42,000 per year, which he supplements with another $3000 by coaching high school basketball and baseball.

The mortgage bankers were comfortable lending Frank $255,000 based on this total compensation package of $45,000. This represents a ratio of debt to income of approximately 5.7, an aggressive ratio, but not unlike what many Americans are being offered today in their respective cities by equally aggressive mortgage bankers.

But this ratio does not tell the whole story. Frank, like the rest of us, has to pay taxes. Even with the interest deductibility he will enjoy on his mortgage, adding up his taxes—federal, state, and local income taxes, property taxes, and unemployment and disability taxes—means that Frank will owe total taxes of $10,000 this year. Frank's total after-tax income therefore will only be $35,000. Based on this after-tax income, Frank's debt-to-income ratio climbs to 7.3 times his expected after-tax income.

Like the rest of us, Frank has minimum budget requirements for essentials such as food and clothing, utilities, and transportation. If we assume that essential, nondiscriminatory spending for Frank's food and other necessities represents another $12,000, that leaves only $23,000 for Frank's mortgage payments and condo association fees. Under the new mortgage, with its attractive new rates, these payments work out to approximately $1500 per month, or $18,000 per year. This means Frank will have approximately $5000 a year to entertain himself and his girlfriend and try to keep gas in his SUV.

More disturbingly, if we look at Frank's debt ratio in terms of his real after-tax free cash flow of $23,000, his debt ratio has ballooned to over 11 times his real free cash flow.

Ratios of debt to cash flow are probably not something the typical reader will have much familiarity with. It is a shorthand method of telling how leveraged a venture, project, company, or individual is—that is, how much debt it has. Such ratios are very familiar to people on Wall Street doing leveraged buyouts (LBOs). A leveraged buyout simply loads on the maximum amount of debt that a company can tolerate in the hopes that management can buy the company with the borrowed moneys and repay the debt over time, thus making them fabulously wealthy.

To put Frank's debt ratio of 11 in perspective, please realize that most successful LBOs, and by successful I mean those that didn't go bankrupt, were completed at debt ratios of between 3 and 6. At the end of the eighties, when the LBO market imploded, transactions were getting done in the range of 7 to 12 times cash flow, but many of these transactions ended in bankruptcy.

So how could bankers be willing to extend so much money to Frank based on his teacher's salary? Surely, Frank's income is not more stable than some of the companies that went private through leveraged buyouts. Surely, Frank's credit is not as good as some of the LBO borrowers such as GE Credit and Kohlberg, Kravis, Roberts & Co. (KKR). No, regardless of how good a coach Frank is, and regardless of how well his teams do or his students perform, there is a very real risk that Frank may lose his job in the future and with it the ability to service his mortgage payments.

The mortgage lender's assumptions must be threefold. One, if Frank loses his job he will be able to find another job with similar earnings power fairly quickly. Two, the housing prices in San Diego will remain remarkably stable, or increase, so that if Frank had to, he could, easily and quickly, sell his condo and repay his mortgage debt in full. Three, if the bank has to foreclose on Frank, the real estate market will allow the bank to resell the unit for at least the amount of the loan balance.

So, to a great degree, Frank and the lenders are depending on housing prices increasing, or at least remaining stable, for the near future. This certainly has been the case historically as housing prices in San Diego, and in the rest of the country, have continued to escalate to new yearly highs. In this book, we ask whether this will necessarily be true in the future.

You don't need to read a book to know that housing prices are high, in almost every corner of America. The challenge in analyzing home prices is to be able to tell whether the prices are justified by economics or are just floating arbitrarily higher, being driven by some noneconomic forces. Many people refer to such a market as a bubble economy, and then try to explain a combination of psychological and behavioral characteristics of humans that might lead to such "irrational exuberance." I will explore some of these possibilities with regard to housing, but I will return to fundamental economics, thinking to explain the "rational exuberance" inherent in today's housing prices. I do not conclude that the pricing of houses today is rational—just that the prices can be derived assuming that the players in the game are each acting rationally. Frank's actions cannot be deemed irrational as he was very well informed about the housing market and its trends, was of sound mind, and acted much like you or I would have acted under similar circumstances. The lending institution also may have been acting rationally as there is a very small likelihood that this mortgage will ever get on the bank's books. Sometimes, a pricing system has endemic problems in it that prevent it from acting like a true market, and thus allows for some rather unfortunate overvaluations and price distortions.

Finally, I will step back from my theoretical exposition trying to convince you that indeed housing prices may be due for a fall, and direct my attention to practical remedies homeowners and prospective homeowners might take to lessen the pain of any price correction. While not possessing a crystal ball, the reader will hopefully see as he walks through my analysis that the times, they are a changin'.

PART I

THE COMING CRASH IN THE HOUSING MARKET

CHAPTER 1

Housing Prices Certainly Look Awfully High

A National Phenomenon

The first three rules of real estate are expressed as "location, location, and location." Real estate is inherently a local business because the value of real estate directly correlates with regional economies and regional demographics. Specific metropolitan home real estate markets also have their own unique market characteristics, and these are examined in Chapter 6. But the present chapter and most of the book look at the United States home real estate market in its entirety.

The reason for such a national analysis, which would seem to violate the above three rules of real estate, is that there are systemic problems in the way that home prices are determined, and these systemic problems are national, if not international, in scope. Although each region of the country has its own unique issues with regard to its economic outlook and home valuations, the nation shares a common methodology for pricing and financing real estate. An inherent problem in the system could affect all areas of the country, albeit to varying

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