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Proactive Investment Management & Financial Planning

Global Perspectives, September 2018: The Long Shadow of the Housing Crisis

This month marks the tenth anniversary of what was arguably the worst moment of the Housing Crisis – the failure of the Lehman Brothers investment bank. That event caused a sharp worsening of the panic and helped make the crisis the most dangerous economic downturn since the Great Depression. As a result of the crisis, millions of people around the world lost their homes, filed for bankruptcy, were thrown out of work, or saw their savings decimated. To this day, the results reverberate throughout the global economy and politics.

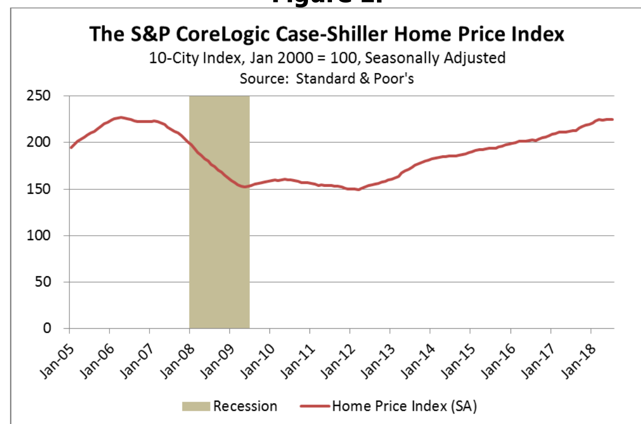
Although it took a long time, the U.S. housing market finally began to recover in the early years of the current decade. By various measures, the market has steadily improved over the last several years. Now, some people are even wondering whether the new upswing in home prices is signaling a second bubble. It therefore might be helpful to provide an update on the health of the housing market and what it means for economic growth and investing.

The Crisis: What Happened?

Different people tend to blame the Housing Crisis on different legal, economic, or financial developments, but the reality is that the cause of the crisis was exceedingly multi-faceted and complex. For a detailed review of the crisis as it played out in this country and abroad, we recommend the recent book ***Crashed***, by Adam Tooze. For purposes of this article, we'll just note that the crisis grew out of a toxic mix of new innovations in finance (such as the securitization of mortgages and the creation of exotic, mortgage-related financial instruments); aggressive new banking strategies (such as an increased focus on trading and fee generation rather than originating and holding loans over the long term); changing public policy (such as deregulation and encouragement for banks to widen their lending to more people); and internationalization (especially cross-border capital flows that helped fuel prices for homes, mortgages, and mortgage-related instruments).

There are multiple ways to measure how bad the Housing Crisis was, but we'll focus on home prices. To estimate the average price of an existing home (in other words, a re-sale), the most common measure is the "median price," or the price at which half the homes are more expensive and half are less expensive. However, that measure can be misleading, since it's heavily influenced by the changing make-up of sales (say, a larger number of condos or starter homes in one period and not another). Instead, we prefer to use the S&P CoreLogic Case-Shiller Home Price Index, which tracks the market value of specific properties over time and extrapolates those values over the whole market. The Case-Shiller index suggests U.S. home prices declined 33.0% from their peak in April 2006 to May 2009. After a tepid effort to recover, prices then fell a bit further over the next few years until they reached their absolute nadir in March 2012, at which point they were down a full 34.2% from their peak (see Figure 1). Given that most people's biggest store of wealth is their house, that price decline was incredibly painful. Since so many homes are financed with a mortgage, the decline in values left a huge share of the population with no equity or negative equity in their home, prompting many to abandon their property and completely immobilizing others.

Figure 1.



Where We Stand Today

Looking at Figure 1, it's clear that the recovery from the Housing Crisis wasn't "V-shaped," as the optimists had hoped. Rather, it was "U-shaped," with an extended bottoming period. Nevertheless, the housing market has staged a prolonged recovery ever since Spring 2012. By July 2018, the Case-Shiller Index was up a full 50.6%

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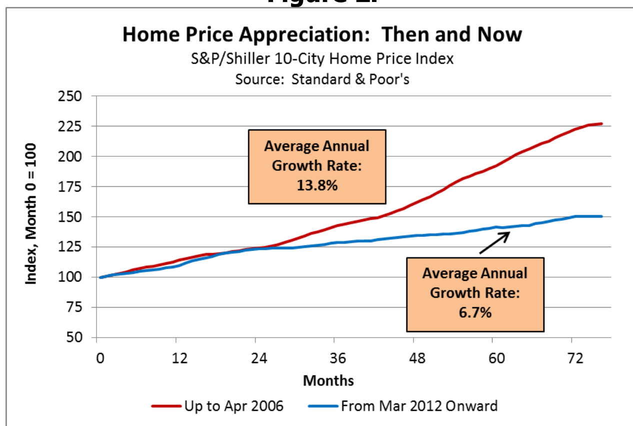
from its low point, and it seems likely that it will finally regain its April 2006 peak in the coming months. Of course, the Index only provides an estimate of the change in the average home price. Many properties have surely recovered much more strongly and are now more valuable than ever before. Other properties are certainly still languishing. In general, however, the data suggest that the housing market has essentially recovered since the very worst point of their decline.

Not only is the recovery in the housing market now widely recognized, but some people are asking whether it's gone too far. We've even heard some people asking whether the market is once again in a bubble. Unfortunately, there is no single, fail-safe way to know that an asset's price has reached the dangerous, unsustainable levels we associate with a bubble. All the same, there are indicators that help, and the ones we follow suggest the market as a whole is not overly hot. For example, even though home prices have been rising nicely since 2012, they haven't been rising nearly as fast as in the run-up to the crisis. In the 76 months leading up to the Index peak in April 2006, prices were rising at a compound annual growth rate of 13.8% per year! In the 76 months since their low point in early 2012, prices have been rising at a much less dramatic rate of 6.7% (see Figure 2). If we exclude the early recovery period and only look at the last four years or so, it's clear that prices have been rising in line with their 20-year average growth rate of 4.9% (see Figure 3).

Figure 2.



Not only are home prices rising in line with long-term trends, but they also remain in line with people's ability to buy them and pay their mortgage debt. To get at that issue, we look at the "Housing Affordability Index" published by the National Association of Realtors. This index measures "whether or not a typical family earns enough income to qualify for a mortgage loan on a typical home," based on the most recent median price of a single-family home, median family income, and mortgage interest rates. The index is designed so that readings of 100 signify that a family with the median income has just enough income to qualify for a mortgage on a median-priced home. Index figures above 100 mean the median family has more than enough income to qualify, while figures below 100 mean the median family is falling short of qualifying. Whereas the index showed very low affordability in the years leading up to the bursting of the housing bubble, it is now hovering around historically high levels (see Figure 4). That suggests houses are historically very affordable, and much more affordable than in the bubble years.

Figure 3.

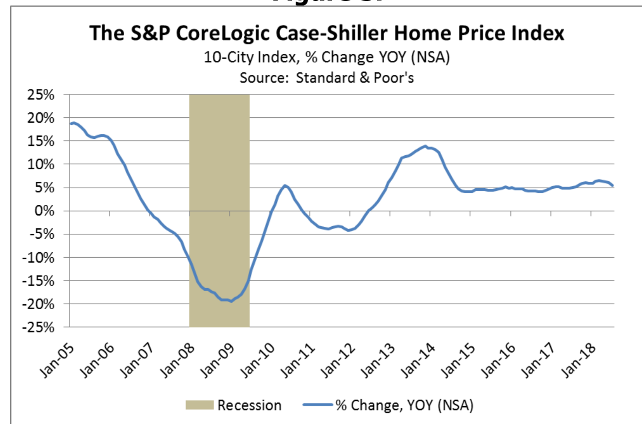
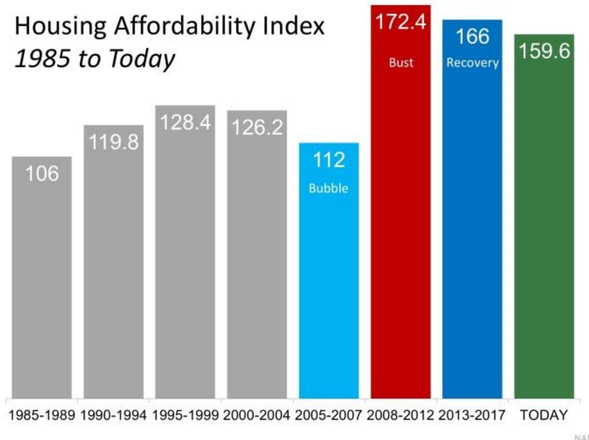


Figure 4.



Of course, one of the hallmarks of the housing bubble was the extremely high levels of debt that people took on and the difficulties they ran into when trying to pay that debt. Separate from the Housing Affordability Index, data from the Federal Reserve gets directly at the question of debt and debt service. As shown in Figure 5, the data indicate that the ratio of Americans' total household debt to their disposable (after-tax) income has declined dramatically from 130.1% at the end of 2007 to just 97.9% in early 2018. The ratio of strictly mortgage

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debt to disposable income has fallen from 105.7% to 72.1% over the same period (the rest of household debt consists of auto loans, student loans, and other types of non-mortgage consumer credit). Even better, the combination of reduced debt levels and historically low interest rates in recent years has meant that the ratio of debt service ***payments*** to disposable income has fallen even more dramatically (see Figure 6). Best of all, each measure has been remarkably steady in recent years, even though continued economic growth and a strong labor market have encouraged spending.

Figure 5.

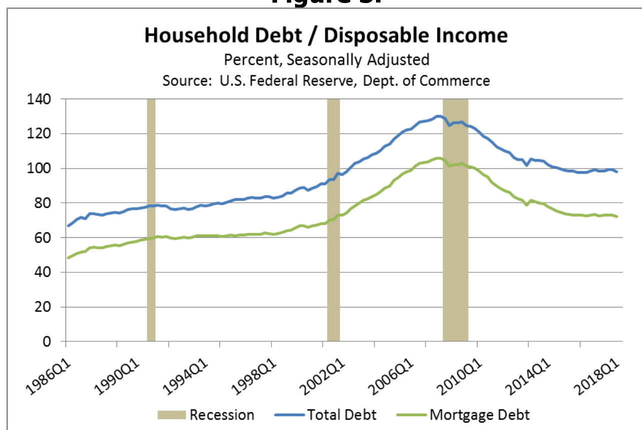
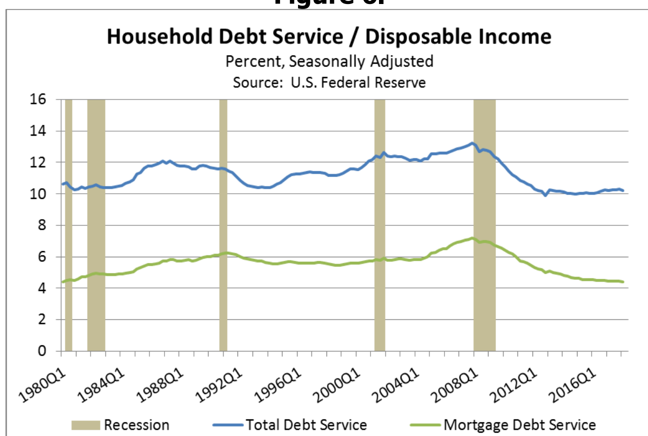


Figure 6.

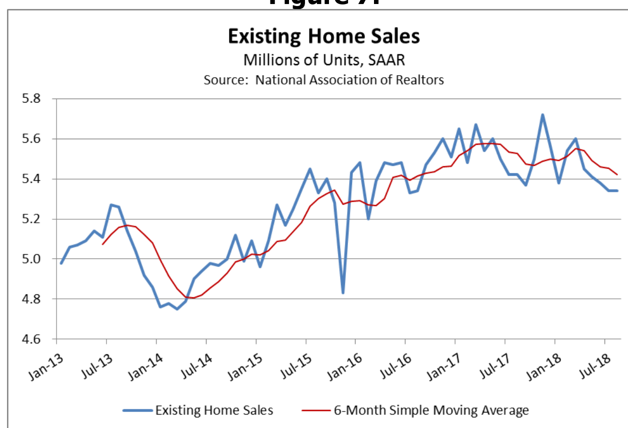


Where We're Going Now

As we look into the future, we're encouraged that the signs don't currently point to another bubble in the housing market. Indeed, a repeat bubble so soon after the last one would be highly unusual. Assets that go through a boom and bust cycle are often hobbled for years afterward. For example, after the bursting of the Tech Bubble of the late 1990s, technology stocks were largely shunned and provided only modest returns for years. After so many people were burned in real estate just ten years ago, we suspect it's far too soon for many to forget that pain and start buying with gusto again. Even if they did want to buy again, financial institutions that suffered through the crisis have become much less willing to lend and have tightened loan standards.

Another reason to think a new housing bubble is unlikely in the near future is that current economic fundamentals are starting to weigh on activity. As we've noted in many other publications, the U.S. economy is now growing so fast that it is outrunning its resource base. Production is increasing faster than supply in a wide range of industries, forcing up prices and putting upward pressure on interest rates. The Federal Reserve has been increasing its benchmark interest rate since late 2015, and it is signaling continued, moderate rate hikes for another year or more. As might be expected, the resulting rise in longer-term interest rates has pushed mortgage interest rates higher. Data from Freddie Mac show the average rate on a 30-year mortgage has increased from its most recent low of 3.42% in late 2016 to approximately 4.60% in recent weeks. That's on top of the on-going rise in prices discussed earlier. Even though homes are still historically affordable, the continued gradual uptrend in prices and interest rates is starting to have an impact. In fact, as shown in Figure 7, the annualized selling rate of existing homes has been trending downward since early 2017.

Figure 7.



Conclusion: Keeping Roles Straight

As we look out even farther into the future (but with the trauma of the Housing Bubble still in mind), we think one of the great questions to consider is simply: What role should my residence have in my plan for creating wealth? We think one of the most important lessons from the Housing Bubble is that it's dangerous to put all your eggs into one basket. Any particular asset – such as technology stocks in the late 1990s or U.S. single-family homes in the 2000s – can run up in prices, creating the temptation to plow all your investments into that one

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asset. As shown by the bursting of the bubble, that can be dangerous to your financial health, as those asset prices can reverse and drop sharply with little warning. We believe it's far better to spread your investments among a range of different asset types. That way, if one asset starts depreciating quickly, other assets might hold their value and cushion the blow.

Just as important, we think there's a critical lesson in the profound pain of millions of people losing their homes and the struggles people faced in trying to get out of their plummeting housing investments. We think a lot of the bad behavior that fed the crisis can be traced to people confusing the role of their home with the role of their financial investments. As the bubble grew, many people began to treat their home as their prime method of building wealth for the future, rather than as their residence. That's a problem because an owner-occupied, single-family home and a diversified portfolio of financial investments are "apples and oranges." In Table 1, we summarize some of the many differences between a principal residence and a portfolio of financial assets. In sum, the main value of your home is providing you with a place to live, and the specific characteristics of a house often means that it doesn't do a good job of creating ready cash for your future. In contrast, a diversified, well-managed portfolio of financial investments like we provide here at WMI is geared specifically for building "liquid" wealth, even if you can't live in your portfolio! Each has its pros and cons, but we believe that the strong historical performance of a diversified portfolio of financial assets is a strong argument for focusing on them for wealth creation and preparing for retirement.

Patrick Fearon, CFA
Chief Investment Officer

Table 1.

Apples and Oranges:
An Example of Why Your Home and Your Financial Assets Should Play Different Roles in Your Financial Plan

Characteristic	Owner-Occupied, Single-Family Home	U.S. Large-Company Stocks
Average Annual Price Growth, Last 20 Years *	4.9%	5.4%
Average Annual Dividend Return, Last 20 Years *	0.0%	2.0%
Average Annual Total Return, Last 20 Years *	4.9%	7.4%
** Single-Family Homes: S&P CoreLogic Case-Shiller 10-City Index*		
** Stocks: S&P 500 Stock Index*		
Ability to Leverage (Purchase With Debt)	Common	Less Common
Tax Deductibility of Interest	Limited	Limited
Subject to Capital Gains Taxes?	No	Sometimes
Subject to Property Taxes?	Yes	No
Annual Maintenance/Custodial Expenses	???	~1% of Value
Easy to Diversify Across Type, Geography?	No	Yes
Fast and Easy to Sell?	No	Yes
Provides a Place to Live?	Yes	No

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