Bringing Down the House

Why home prices won't rise again

By Charles Hugh Smith

THE FINANCIAL MEDIA and government officials are looking for a recovery in the housing market to "restart the economy." The entire world—or at least every exporter from Shanghai to Bonn who is desperately dependent on the free-spending American consumer—is hoping that housing is about to re-ascend to its glorious bubble-era heights. But that is not going to happen—not this year, not even in ten years, for several fundamental reasons.

1. Bubbles do not re-inflate in the asset class that just popped. Tulip-bulb valuations did not rise again to stratospheric heights after the Tulip Craze went bust, nor did the NASDAQ dot-com bubble re-inflate, for the very good reason that bubbles are never based on rational valuations. They are the result of a psychological state of mania that cannot be reinstated once lost.

Consider tech stock Cisco Systems, a well-managed "real company" that continues to make profits providing goods and services. Having replaced the bankrupt General Motors in the Dow Jones Industrial Average, Cisco currently trades at around $17 a share, down from its dot-com bubble valuation of about $81 per share.

To recover its bubble-era valuation, Cisco would have to rise fivefold. That's highly unlikely. Now that the hysteria has dissipated, Cisco is valued on more rational metrics like earnings, profits, and cash flow.

Mania always moves on to a new asset class. After the dot-com bubble, speculators turned to housing. Once the housing bubble collapsed, the mania shifted to the bond market. Now that the bond bubble is bursting—that spike to nosebleed territory in December 2008 was the dead giveaway—the only asset class that hasn't already been blown into a bubble is precious metals and gold.

2. Inflation sets the "recovery" target ever higher. While we are in a deflationary period right now, a serious amount of inflation occurred between Cisco's peak in January 2000 and the present. According to the Bureau of Labor Statistics' inflation calculator, $81 in 2000 is $100 in current dollars. So Cisco would have to rise by that much more to match its bubble-era valuation. The same is true for housing.

Let's say a house that sold for $100,000 in 1995 was valued at $400,000 at the housing-bubble peak in 2006. If history is any guide, then housing will retrace to its pre-bubble valuation, as that is the usual progression of bubbles and their demises.

Now if inflation ramps up and ravages the value of the dollar, the price of a tangible good like a home might well rise more or less along with inflation, as people will be trying to turn their rapidly devaluing dollars into some tangible good as a means of preserving capital. But if inflation is clipping along at 10 percent a year, and the house returns to its bubble-era value of $400,000, that $400,000 doesn't retain the same purchasing power as it did in 2006.

Consider the stock market in the inflationary period of the 1970s. While the market wobbled from 1,000 in 1966 to 1,000 in 1982 16 years later, inflation destroyed two-thirds of the value of the dollar. According to the Bureau of Labor Statistics, which tends to understate inflation so as not to alarm the masses unnecessarily, $1 in 1966 was worth 34 cents in 1982. Thus people who held stocks for those 16 years did not retain their wealth as the Dow Jones retouched the magic 1,000 mark—they lost two-thirds of their investment.

It is easy to foresee the same thing happening in housing should inflation ignite. Over the next 16 years, the house that sold for $400,000 in 2006 may well rise once again to that nominal price, but the inflation-adjusted value could well be closer to $100,000 when priced in (pre-housing bubble) 1995 dollars.

This is why nominal prices in stocks, housing, and bonds are essentially meaningless. All assets have to be valued in terms of purchasing power, and as imperfect as any inflation/deflation gauge might be, it's still a better guide to purchasing power than nominal price.

3. Perhaps counterintuitively, deflation also ravages bubble-era valuations. You might think that because inflation is tough on bubble-era valuations when priced in purchasing power (or some non-paper metric like gold), then deflation would be dandy. But deflation wipes out bubble-era valuations just as assiduously as inflation does.

In deflation, debt grows ever more burdensome as cash becomes scarce and wages and income drop. As a result, assets dependent on leveraged debt such as real estate drop in value. In deflation, real estate becomes a capital trap, which loses value as cash gains in value. As incomes plummet, so do rents, the income stream that real estate brings, further impairing its value.

Deflation often accompanies depression, and nothing is more of a capital trap than an empty house or building earning no income. Compared to that negative return—recall that cash-starved cities and counties will still be collecting property taxes on vacant property—cash that is earning interest looks very attractive. This capital flight creates another drag on housing valuations.

So whatever the future holds—deflation, inflation, or periods of one following the other—housing will never return to its bubble-era valuations when measured by purchasing power adjusted for inflation.

4. The fundamental driver of the housing bubble was once-in-a-lifetime low interest rates and loose lending. Bond yields and thus interest rates tend to move in generational cycles of about 20 years—occasionally as short as 17 years and as long as 27 years. The current decline in yields has now run 27 years, the historical maximum for such cycles, thus we can anticipate that yields and interest rates will be rising for the next generation.

Why would interest rates rise? Easy. The U.S. is borrowing trillions of dollars a year, and once the rest of the world either runs out of cash or the desire to give us all their surplus capital, interest rates will rocket regardless of what the Fed or U.S. Treasury do. Picture our financial royalty standing knee-deep in a rising tide demanding that the waters recede. Good luck with that, fellas.

As for loose and/or fraudulent lending, you know the story. Though there are many causes for the housing bubble's expansion and collapse, this is the most basic: the bar for qualifying for a mortgage was lowered to near zero. This can be illustrated by a steeplechase analogy in which the prudently high mortgage qualification hurdle of "20 percent down, verified income, and no more than 35 percent of income devoted to a mortgage" was replaced by one mere inches in height. Everyone with a pulse and the will to stretch the truth not only qualified for the race, they all crossed the finish line with flying colors. Is it any wonder that millions of marginal buyers leaped in? Their marginality was quickly revealed, however, once they left the track and returned to real life.

Now that the entire charade of passing off millions of highly risky, doomed-to-default mortgages via securitization to unwary investors has ended, risk avoidance has led not just to a return to higher qualifying standards but to a raising of the original bar. In the post-bubble aftermath, the hurdle not only excludes marginal risky borrowers but some of those who might have qualified before the bubble mania infected the housing and lending markets.

So if fundamental drivers of insanely low interest rates and loose lending are not coming back, then precisely what forces will re-inflate the housing bubble? The answer: none.

Demographics? Housing density has been falling for decades. Everyone wanted not just his own room but his own condo or house. As the density trend reverses course (greetings, returning unemployed offspring—your room is untouched since you left for college), all future population growth can be easily accommodated by the existing housing stock.

Speculative mania? That drunken circus came to Housing Town and left, never to return in our lifetimes. If you're 3 years old you may live to see another housing bubble in your dotage.

5. The bull market recession-recovery cycle is broken. Standard-issue financial pundits are hopelessly blinded by their Cargo Cult belief—in which you paint a rock to look like a radio and then use it to plead for the return of well-stocked Liberty ships—that the long postwar era of prosperity is still intact.

For the past 60 years, the cycle was predictable: a recession would wring out credit and inventory excesses, setting up a recovery. But the mechanisms that provided stability to the U.S. economy are now broken. The global credit market dislocations, the extremes of leverage still not unwound, the accounting trickery and fraud still lurking in countless balance sheets (or even worse, in off-balance-sheet accounts), the unprecedented destruction of middle-class wealth—these factors plus another dozen or so too enervating to list require us to face the disagreeable conclusion that we are in uncharted territory, and appeals to rock radios ("green shoots") are unlikely to hasten the return of prosperity.

Even worse, our government is straining with every fiber of its vast being to extend the excesses of credit, debt, and leverage that created the housing bubble and guaranteed its collapse. The catastrophically bankrupt state of California managed to find $100 million to help residents buy sparkling new homes—never mind the hundreds of thousands of perfectly livable homes now on the market.

We can safely predict that all the blandishments of bankrupt governments attempting to re-inflate the housing bubble have approximately the same chances for success as pleas screamed at a gaily-painted rock.

But there is a funny little mechanism called the free market, which has a long history of resolving credit/debt/leverage/valuation excesses by enabling prices of assets, be they mortgages, homes, land, or derivatives, to fall to the point that entrepreneurs can pick up the pieces and actually turn a profit.

In a similar fashion, the bloated inventory of unsold vacant housing will magically decline once the price of owning a house falls substantially below the cost of renting a house. In other words, when it actually makes financial sense to buy a house and live there rather than gambling on its value as a leveraged speculation, people will act in their own self-interest, and a real recovery—not one based on a speculative bubble in housing—will finally become possible. ■

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DEEPBACKGROUND

Once you've developed a taste for regime change, apparently it's hard to stop. Rahm Emanuel, President Obama's chief of staff, is coordinating a White House effort to remake the Israeli government. His father Binyamin, a doctor and former Irgun terrorist, is the closest thing Israel has to homegrown royalty. Emanuel himself served in the Israeli army during the first Gulf War, vacations in Israel, and has extensive personal connections that span the country's political spectrum. The Obama administration, discouraged by reports that Prime Minister Binyamin Netanyahu disparaged and even ridiculed the U.S. president's Cairo speech (even though Israel had been carefully briefed in advance), has begun a low-key unofficial effort to replace the country's leadership. The choice of Rahm Emanuel, a pro-Israel hardliner, to head the campaign is intended to limit criticism that there might be an anti-Israel agenda at work.

Obama believes Netanyahu will not be able or even willing to move his predominantly right-wing government toward the American objective of a two-state Israel/Palestine solution. Without such an outcome, the administration believes it will be impossible to advance to phase two of its broader Middle Eastern policy, which is the gathering of moderate Arab nations into a league with the U.S. to forestall Iran's drive to become a regional hegemon and nuclear power. There is particular concern in Washington that Tehran is extending its influence to include radical Sunni groups, as it already co-operates with Hamas. Attempts to convince Israel to make some major concessions in exchange for an American pledge of action on Iran have not worked, with Netanyahu going on the defensive and proposing a series of half measures intended only to buy time.

Emanuel, who will suggest to prominent Israelis that Netanyahu's continued leadership role is not desirable, has carefully covered himself by discussing his plans with a number of American Jewish Democratic Party leaders. Most are supportive. Congressman Gary Ackerman (D-N.Y.) favors former Israeli minister of foreign affairs Tzipi Livni to replace Netanyahu. Livni has close relations with Emanuel and Secretary of State Hillary Clinton, as well as with many in Congress. She is viewed as both a moderate and a realist, and it helps that she actually outpolled Netanyahu in the last Israeli election, though she was unable to pull together a coalition.

Clinton is helping the Emanuel effort by making negative comments about Netanyahu's reliance on extremists, including Minister of Interior Avigdor Lieberman, who supports racist legislation directed at Israel's Arab minority and who recently confirmed planned expansion of West Bank settlements in defiance of Washington. Emanuel believes that Netanyahu will probably not be able to maintain his coalition in power for more than the next several months, particularly if subjected to sniping from Washington, due to defections from already disgruntled Labor Party politicians. That will give Livni and her Kadima Party the opportunity to resume power. Not surprisingly, Netanyahu is aware of what is going on.

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