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House of cards

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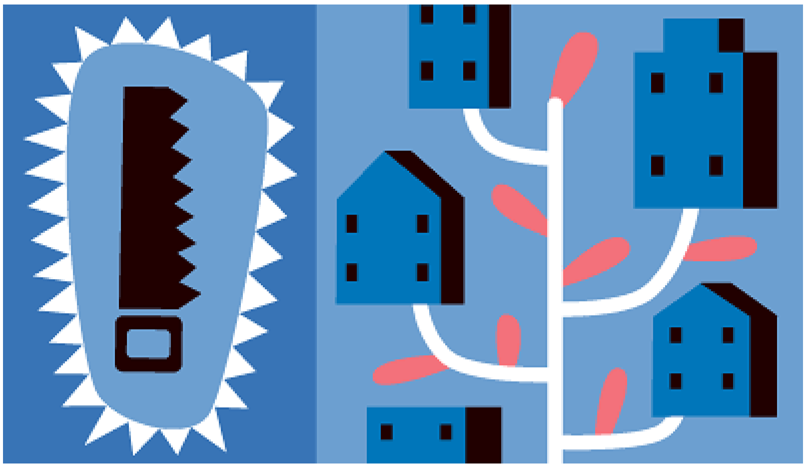


In many countries the stockmarket bubble has been replaced by a property-price bubble. Sooner or later it will burst, says Pam Woodall, our economics editor

"BUYING property is by far the safest investment you can make. House prices will never fall like share prices." This is the advice offered by countless estate agents around the globe. In the absence of attractive investment opportunities elsewhere, home buyers have needed little encouragement: from London to Madrid and from Washington to Sydney, rising house prices have been the hot topic of conversation at dinner parties. Over the past seven years, house prices in many countries have risen at their fastest rate ever in real terms. And now institutional investors are also eagerly shifting money from equities into commercial property. Many property analysts scoff at the suggestion that another bubble is in the making. House prices may have fallen after previous booms, but "this time is different", they insist. That is precisely what equity analysts said when share prices soared in the late 1990s. They were proved wrong. Will the property experts suffer the same fate?

This survey will examine investors' current love affair with both residential and commercial property (or real estate, as Americans call it). It will explore the latest trends in property prices around the globe and consider different methods of estimating fair value in order to assess whether there is a bubble. This may well be the single most important question currently hanging over the world economy. Given the fragile state of many economies, the bursting of a housing bubble could easily drag them into recession.

Property is probably the biggest business in the world. By one estimate, construction, the buying, selling and renting of properties and the imputed benefits to owner-occupiers account for around 15% of rich countries'GDP. Property also makes up around two-thirds of the tangible capital stock in most economies. Most important of all, property is by far the world's biggest single asset class. Investors have much more money tied up in property than in shares or bonds (see chart 1).

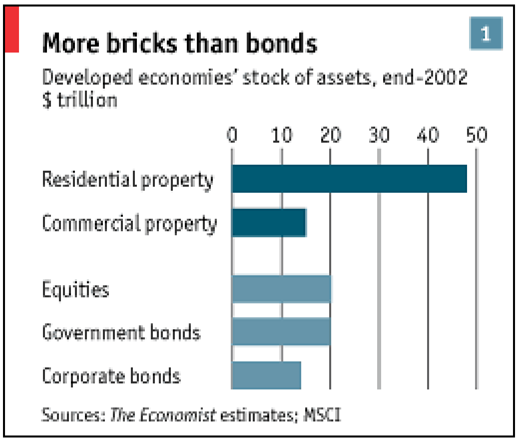
A lot more people own homes than own shares. In all the big developed economies bar Germany, well over half of all households are home-owners (see chart 2). In most of Europe and Australia, housing accounts for 40-60% of total household wealth, and in America for about 30%. And even in America the typical household on an average income holds six times as much wealth in residential property as in shares.

Yet, curiously, there has been much less economic research into the property market than into the stockmarket, the bond market or the foreign-exchange market. One reason is that until recently much of this property investment was held fairly passively. For most people a home was simply a place to live. For most firms offices were a necessary but relatively unimportant part of their infrastructure. Commercial property made up less than 5% of most institutional investors' portfolios. But now many people, having lost faith in shares, see their home as an investment that will appreciate rapidly in value. Financial institutions are also pushing up the share of commercial property in their portfolios. To both sorts of investor, property seems to offer attractively high returns—as well as a safe haven in an increasingly risky world.

Betting the house

Over the past few years, house prices have been booming almost everywhere except Germany and Japan. Since the mid-1990s, house prices in Australia, Britain, Ireland, the Netherlands, Spain and Sweden have all risen by more than 50% in real terms. American house prices are up a more modest 30%, but that is still the biggest real gain over any such period in recorded history. Commercial-property prices in some big cities have also been looking rather frothy.

These property booms have been partly driven by economic fundamentals, but bubble-like symptoms abound. Real-estate investment has even made it into a TV series, “The Sopranos”. In one recent episode, the wife of Tony, the Mafia boss, suggested he invest in a real-estate investment trust (a fund which enables small investors to buy commercial property). Many viewers took her advice.



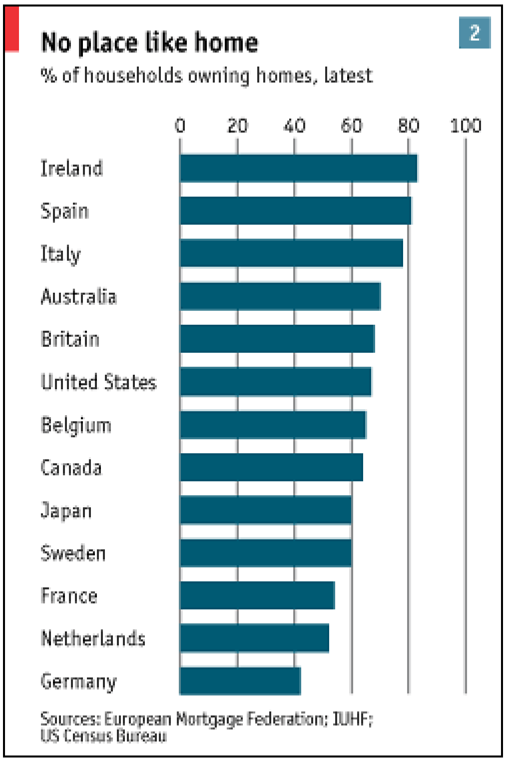
Rewards from investing in property in the past are certainly impressive. In Britain, for example, over the past ten years the total return from both commercial and residential property (including rental income) has been well over 10%, beating the return on equities or gilts. Over the past three years, British house prices have risen by 55%, whereas share prices are 40% down.

Over the past ten years, the total return from buying a house (including the implicit rental income) has exceeded the return from shares in half the countries in chart 3. But these figures understate the possible gains from investing in property. Unlike equities, most homes are bought with borrowed money, and the resulting leverage can greatly lift the return on the initial stake (or increase any loss). Suppose you had invested $20,000 in shares, which after five years are now worth $40,000, including reinvested dividends, implying an annual return of 15%. Then suppose you had used the $20,000 as a deposit on a $100,000 house that over five years had risen in value by a more modest 7% a year, to $140,000. Assume, for simplicity, that mortgage-interest payments and maintenance costs exactly offset the rental income. The average annual return on your deposit would have been almost 25%.

In addition, the taxman tends to treat housing far more favourably than financial assets. In most countries, owner-occupiers get tax relief on their mortgage interest payments or first-time buyers get a tax credit, and owner-occupiers are at least partially exempt from capital-gains tax. Admittedly the transaction costs of buying and selling property are high, but on reasonable assumptions the after-tax return from housing over the past decade has exceeded that from shares in most countries.

How long can the party last? Estate agents, builders, lenders, many economists and even Alan Greenspan, chairman of America's Federal Reserve, have all insisted that there is no house-price bubble. Rising house prices, the argument goes, are fully justified by low interest rates, rising real incomes, growing populations and a fixed supply of land. But this sounds a little like the “wall of money” argument used to defend inflated share prices in the late 1990s. Prices had to rise, it was said, because the number of shares in which pension funds could invest their billions was limited. Investors mistakenly came to believe that the traditional link between share prices and profits no longer mattered. Home-owners may be making a similar mistake today.

It is often argued that property is a much safer investment than shares because a share is just a (possibly worthless) piece of paper, whereas bricks and mortar are something tangible. Yet that tells us nothing about their relative value. Bubbles form when the price of any asset gets out of line with its underlying value.



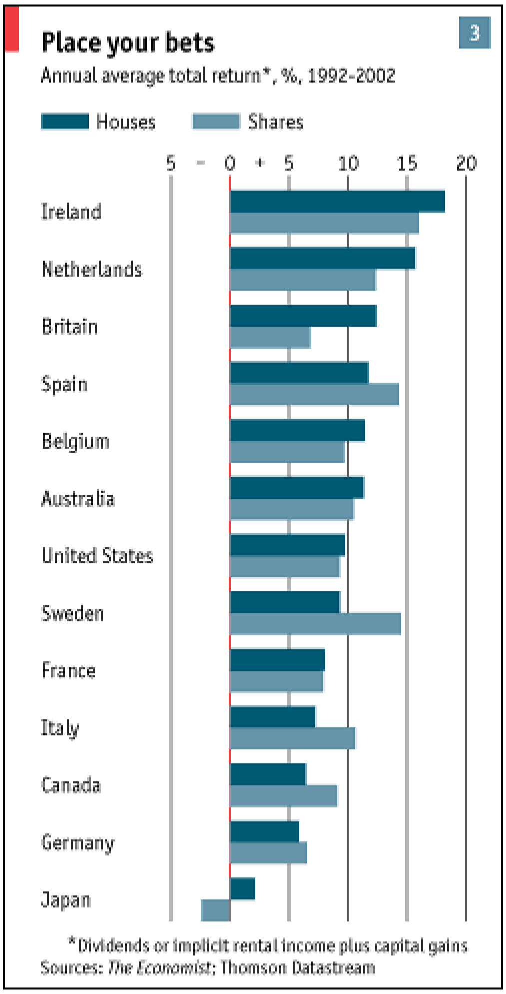
Home prices are not listed daily in the *Financial Times*, but the same sort of valuation analysis can be applied to houses as to shares. The price you pay for a property should reflect the future rent at which you could let it. The fact that in many countries prices of homes and commercial buildings have been rising much faster than rents should be ringing alarm bells.

Housing is just as prone to irrational exuberance as is the stockmarket. Property is increasingly viewed as an easy way to make money. People buy a home in the expectation that its price will continue to rise strongly over time. Such expectations lie at the heart of all bubbles. Given the boom in the property market over the past few years, at the very least house-buyers betting on further rapid house-price gains are likely to be disappointed. Worse, there is a risk that house prices will take such a tumble that they take whole economies with them.

Vicious cycles

Swings in property prices can have a big impact on economic growth. Since the IT and stockmarket bubbles burst, rising property prices around the globe have helped to prop up the world economy. Rising house prices have boosted consumer spending by making people feel wealthier, offsetting the effect of falling share prices. Consumers have also been able to borrow more against the higher value of their homes, turning capital gains into cash which they can spend on a new car or a holiday. For firms, property is the main form of collateral for borrowing, so swings in commercial-property prices can also influence corporate investment.

But just as rising house prices help to boost spending, so falling house prices can cause economic pain. In an analysis of a number of earlier housing bubbles, the IMF's latest *World Economic Outlook* found that output losses after house-price busts in rich countries have on average been twice as large as those after stockmarket crashes. The average real decline after a house-price bust has been more modest than after a stockmarket crash (30% over four years against 45% over two-and-and-half years), but at the end of that period GDP had fallen by an average of 8% relative to its previous growth trend, compared with 4% after a share-price bust. The IMF also found that a sharp rise in house prices in real terms is much more likely to be followed by a bust than is a share-price boom.



There are three reasons why a house-price bubble might cause more harm on bursting than a stockmarket bubble. First, house prices have a bigger wealth effect on consumer spending, largely because more people own their homes than own shares. A study of 14 countries by three American economists, Karl Case, John Quigley and Robert Shiller, found that in most economies a change in property prices had at least twice as big an effect on consumer spending as a change in share prices of the same order.

Second, people are much more likely to borrow to buy a home than to buy shares. Some of them inevitably borrow too much and later have to curb their spending. Third, a decline in property prices also leaves some households with homes worth less than the amount they have borrowed, so housing busts have a greater effect on banks, which are typically heavily exposed to real estate. Falling house prices lead to an increase in banks' non-performing loans, and as their collateral shrinks, so does their capacity to lend.

This survey will conclude that the latest housing boom has inflated bubbles in several countries, notably America, Australia, Britain, Ireland, the Netherlands and Spain. Within the next year or so those bubbles are likely to burst, leading to falls in average real house prices of 15-20% in America and 30% or more elsewhere over the next few years, in line with average price declines during past housing-market busts. This time, however, with inflation so low, house prices will fall more sharply in money terms than they did in the past. In Britain as a whole, for example, average nominal house prices are likely to drop by 20-25%, and in London by much more. Significant numbers of owners may be left with homes worth less than their mortgages—especially as the proportion of owner-occupiers with mortgages exceeding 80% of the value of their homes is higher now than it was in the previous bust in the early 1990s.

There are already signs in some cities, such as London, New York and Amsterdam, that the housing market is cooling fast, but estate agents still insist that prices are unlikely to fall by much. Tell that to the couple who bought a four-bedroom house in San Francisco for $2.1m in 2000, then divorced and had to sell the house only two years later for $1.45m.