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State of the Market 47: After the Bottom

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The nation's housing markets have reached bottom.

Yes, they have.

Now what? Where does one move, especially in multifamily?

We in multifamily actually care about *three* markets: the national economy, the homeownership market, and the rental market. Of these, the rental market turned positive a year and a half ago, as I showed in the previous *State of the Market,* and is rising strongly. Now the homeownership market has stabilized; yet the national economy continues to drift sideways and down.

In your planning, don't be distracted by the looming Presidential election. Regardless of which candidate wins or the composition of House and Senate, the real estate dynamics we will face when we come to work on Wednesday are exactly the same, and the ecosystemic challenges we face will swamp the marginal effects of any particular legislative proposal. So stop watching the bobbing corks in the political bathtub and take note of the tsunami outside your window.

With a price bottom, coordinating your corporate strategy is tricky, for it requires moving among these three asynchronous biorhythms, each of which affects the other two.

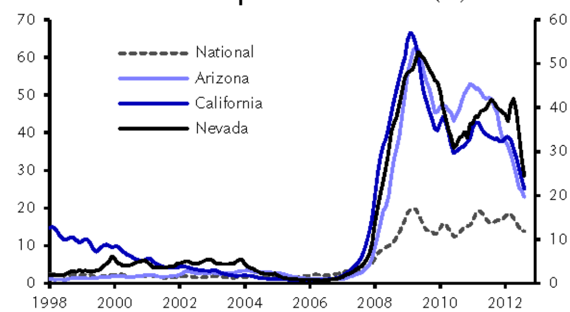
This really is a housing bottom, even if tenuous

Evidence both micro and macro demonstrates that we have finally passed

"Is it safe to open the acquisition files?"

the house-price nadir. Data compiled and presented by Capital Economics[1] (including the handy chart presented below) and others shows, among other things, that:

Chart 1: Share of Home Sales Where the Property Was Foreclosed Upon in the Past Year (%)



- After peaking in 2007, the inventory of existing homes for sale is down to its historical average of 2,500,000.
- The percentage of home sales tied to foreclosure (see chart above), which peaked at 60% of the inventory in Arizona, California, and Nevada, is down threefold in those hard-hit states, and is a still-scary-but-declining 11% nationally.

[1] Capital Economics' reports are spectacular, incisive and loaded with statistics. Lead economist Paul Diggle and his team do a stellar job: highly recommended. www.capitaleconomics.com.

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- The shadow inventory (vacant or seriously delinquent homes) has been declining slowly for 2½ years, after having risen dizzily between 2007 and 2010.
- According to CoreLogic, year-on-year house prices are up about 5%.
- The Case-Shiller index of price-to-rent ratios is at its lowest point in 35 years, and according to their arithmetic ownership is 20% underpriced relative to rental.
- My house is now worth more than we paid for it eight years ago – and in the world of solipsism, what is true for me is true for everyone, isn't it?

However, much of this price support is itself artificially sustained. The real unemployment rate, the U-6 (people out of work, marginally attached, and those working part-time for economic reasons), is at a withering 14.7% and won't come down much any time soon. The affordability of homeownership is itself propped up by Fed Chairman Bernanke's commitment to printing ever more money to hold Treasury rates at unheard-of-bargain-basement levels; yet despite this, spreads (the gap between Treasuries and mortgage rates) remain extremely wide, in the range of 300-325 basis points, suggesting that mortgage rates too have gone as low as they can. When base rates rise, as they must given our farcical and unsustainable budget deficits, then much of the capitalized value now holding up home prices will be eroded away.

In short, average national home prices won't fall any further (though some markets are in structural decline), but no one should be buying houses now in anticipation that they will be wealth-builders or guaranteed retirement savings.

Strategy in the time of fragile price recovery: think past discontinuity

As the man said when the hurricane eye passed directly overhead, "Gee, the weather sure cleared up nicely, didn't it?" Though things are improving, recoveries are themselves unstable. More change is coming, and the portents are ominous. They can be divided into two groups: enduring verities and intermediate inevitabilities.

Enduring verities. Some things were true a decade ago, are true now, and will be true two decades hence. These include:

- *American urbanization*. We continue to move to metropolitan areas because that's where the money is.
- *American migration*. Americans are the most mobile people in history, though the housing recession has slowed that down for half a decade. We will keep moving warm, wet, and west.
- *American immigration*. We are the world's immigration-destination of choice. This is a *huge* national competitive advantage and we must not mess it up.
- *Rising real energy costs*. Occasional eddies aside, whatever it costs today, it will cost more in a year.
- *Information's value premium*. More and more of value creation will be information-based.
- *Bandwidth goes to infinity, cost to zero*. Value chains and supply chains can be dispersed in space because they can be instantly connected in cyberspace.

All these forces are, at least for the next decade, as reliable and immutable as gravity. Bank on them.

Intermediate inevitabilities. Over the next five to ten years, many discontinuities are inevitable. The budget deficits are historic, unprecedented, and unsustainable. Student debt has cracked $1 trillion and despite editorializing is not being reined in. Tax reform is inevitable lest the Alternative Minimum Tax assimilate us all. CRA needs overhaul. One day soon inflation will be recognized as having jumped (have you bought gas lately?). So will interest rates. This means that:

- *More things get taxed*. We will tax more things … because we have to. What we tax will be that which is politically taxable (i.e. either vilified or cheaper to rationalize). So … carbon will be taxed. Banks; existence and banking transactions will be taxed. Marijuana will be legalized and taxed (we are in the dispirited endgame of Mary Jane Prohibition). About the only thing that *won't* be newly taxed is the internet, because it's too fast-moving and protean and even elected officials realize they'll be chasing wisps.

- *Rents will rise faster than inflation*. Though the population of America continues to rise, what drives demand is households, and during the last few years, households declined – both through external emigration out of America and for internal immigration back into larger and possibly extended families. That caused rents to fall while real inflation (what people pay, as opposed to the artificial CPI) rose. Now, as the housing market stabilizes, households re-emerge. Meanwhile, production of new homes largely stopped for four years. Already we're seeing rents rise faster than notional CPI inflation. This trend will continue, even if (as I expect) inflation not only rises but also is widely seen to rise.
- *Student debt obligations will be restructured*. Though this isn't my area of expertise, to be sure, but you cannot indenture a whole generation with a trillion dollars (yup) of non-dischargeable debt without doing crippling damage to economic recovery, household formation, and real estate price rises. Either the debt gets cut, or deferred, or devalued (via inflation). In predicting this, I have absolutely no idea how or by whom it could be done; but done it must be, and by someone.
- *Tax reform*. Politically, no higher tax can ever be sold as such; instead it must always be packaged as a *reform*. Today the United States spends upwards of $120 billion annually on a regressive quasi-entitlement for the middle class known as the Mortgage Interest Deduction. While the MID is impervious to frontal assault, flanking attacks (such as trimming the MID for second homes, or loans above a certain size) are probable.
- *The Community Reinvestment Act will be expanded.* A variant of taxing something unpopular, a CRA expansion will create progressive capital flows from the banks toward low-income communities. Though gnarly, broadening CRA can be approached from either political perspective, and if artfully managed, can both gain the middle ground and deliver some much-needed revenue/ impact amid a Federal government furiously hacking away at its entitlements.

Party like it's 1977

When all that happens, what does it mean for multifamily? Turbulence and tight credit are times of stress; inflation and rents rising faster than inflation are times of opportunity. The effort to rein in inflation kicked off by pent-up corporate response to emergent demand will push an inflation-fighting Federal Reserve to raise short-term interest rates.

The scenario I've just painted has a precedent: the five years of economic recovery that began in 1977, a couple of years after I got into this business, and ended in 1982. Back then a recession made worse by an arbitrary spike in energy costs drove America into a severe recession, high costs of living, and a real estate crunch. Massive numbers of affordable and rental properties failed; at one time over 85% of all HUD properties in the State of Ohio were in default. To emerge from this brought us stagflation, as it was known, and high structural inflation, ranging from 6-7% to a high of 13%, a level so debilitating it threatened the US economy's viability. To break the stagflation cycle, Congress in 1981 enacted sweeping tax cuts (which worked, giving the economy genuine and immediate stimulus), and the Federal Reserve (in the person of Paul Volcker) prescribed nosebleed interest rates (which peaked at 21% just as I was buying my first home, a condominium).

It was an economically brutal five years – and it was the best time to buy real estate in the last thirty years. Trouble could be bought cheap; in fact, sometimes one could be *paid* to take on trouble, if one was prepared to take on the accompanying uncertainty.

As Yogi Berra said, it's déjà vu all over again. Get ready to buy.

What to do now

1. When it comes to a slowly firming bottom, precise timing is less important than deciding. Being a bit early is better than being late.
2. Buy quality. Whether that is in location, construction, physical configuration, ownership, or property management, stress times widen the spread between best and average, between average and poor. Quality rebounds quicker and its upside is greater.
3. Borrow long at fixed interest rates. Even with the wide net spreads banks are charging on the free money Ben Bernanke is lending them, all-in nominal rates are at fifty-year lows. Borrowing long fixed is a call option on inflation, sold to you at a very cheap price.
4. In real estate, inflation makes geniuses of us all, especially if you've borrowed long fixed. (Conversely, it impoverishes the elderly.)
5. Buy trouble. Buy complications. Buy disputes. Then offer cash, at deep discounts, to those complaining.
6. If you buy trouble, over-fix it. Though that may depress your IRR according to the analyst's Excel spreadsheet IRR, in the world of real it lowers your blood pressure and reduces your risk of needing a restructuring … and post-acquisition restructurings are always really, really painful.
7. Don’t worry about competition from single-family homes being rented. That's a buy-to-let strategy and those entrants will exit the market as soon as occupant-ownership prices return to a semblance of historical levels.
8. Buy optionality, and pay a premium for it. Your ideal position is one where your downside is fixed (because you have fixed-rate debt), even if large, and your upside is variable. Buy control. Buy scale.
9. Buy portfolios but recognize, as a good friend of mine put it, that in your typical portfolio 25% of the properties will represent 125% of the portfolio's value. To get the gems, you must take the millstones.
10. Protect your brand and your track record. It is, or will become, a huge intangible asset that is self-renewing if you vigilantly defend it.

Finally, bear in mind that in half a decade, looming inflation will be the revenge the young take upon us baby boomers for overspending our national capacity … but that's a topic for another *State of the Market* perhaps five years hence.