MacroMavens

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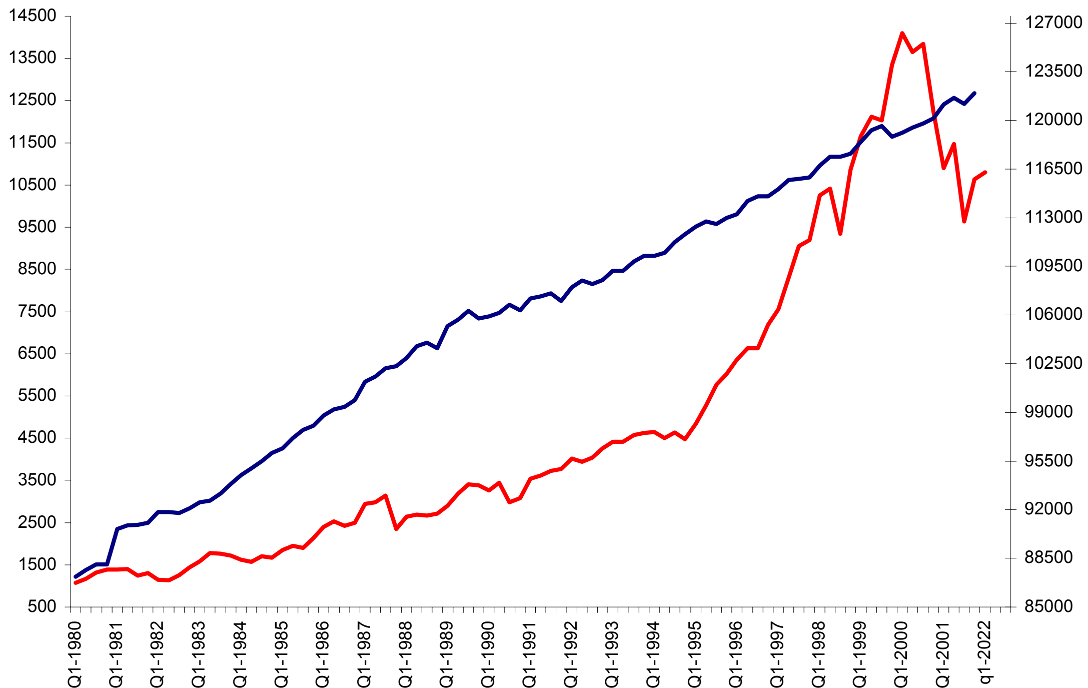
The Great Bubble Transfer

Either by simple serendipity or in yet another flawlessly orchestrated performance by the Maestro, the U.S. has quietly undergone the greatest ‘Bubble Transfer’ in history.

The $3 trillion in wealth that was so abruptly lopped off the top of the Wilshire since its peak in March 2000 has miraculously resurfaced in the real estate market where homeowners have seen the value of their homes appreciate $2-3 trillion over the same timeframe.

Housing Wealth vs. Stock Market Wealth
$Billions



Like the bubble in financial assets, the new real estate bubble has its own distinctly disturbing characteristics. For example, one could argue, and quite cogently, that **the home has become the new ‘margin account’** as consumers through popular programs like ‘cash-out’ Refi increasingly leverage against unrealized gains in their single largest asset.

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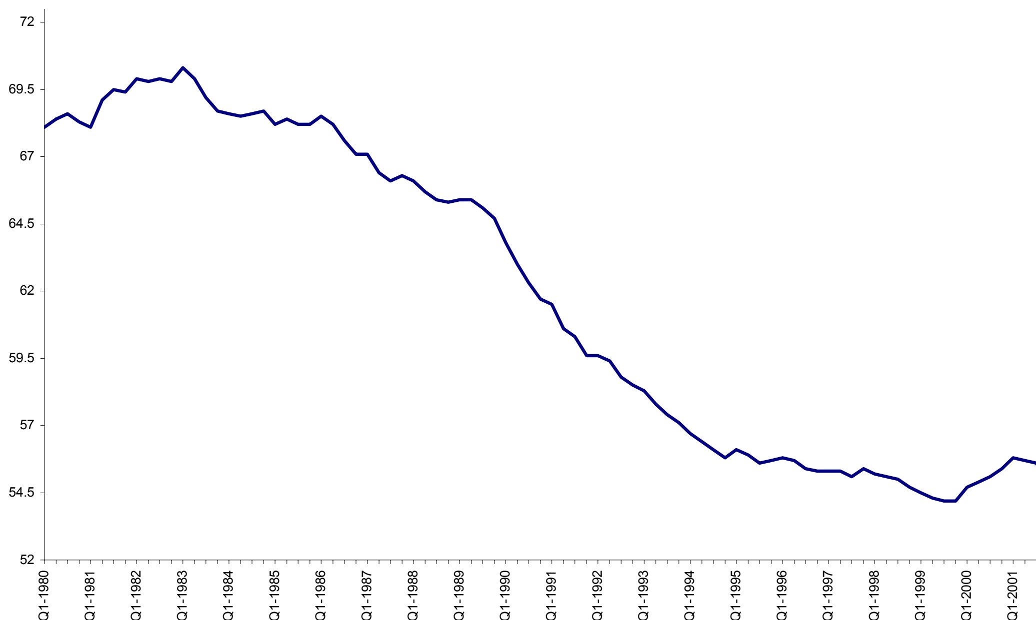
Perhaps the most disturbing hallmark of this Refi mania is the corresponding plunge in homeowners' equity stake, especially in an environment where secular lows in both the Unemployment Rate and Mortgage Rates would suggest just the opposite would occur.

Homeowners Equity % Home Value



The cash-out Refi numbers reveal a 'speculative fervor' that makes the Nasdaq mania look tame. According to estimates by Fannie Mae**, the *average* cash-out Refi is $34,000**. This sounds like a lot to me, particularly considering that **the median home price is just $150,000**…e.g., the average Joe is extracting 20% of his home value!

In total, Fannie Mae estimates that $75 to $80b will be drawn out of homes this year with about 60% of that cash being spent with the remainder being used to pay down high interest debt. (The Fed expects over 70% to be spent). Either way, this translates to about $50-55b increase in consumption, or one full month's worth of annual Personal Consumption Expenditures.

So the impact on consumption is both real and largely quantifiable.

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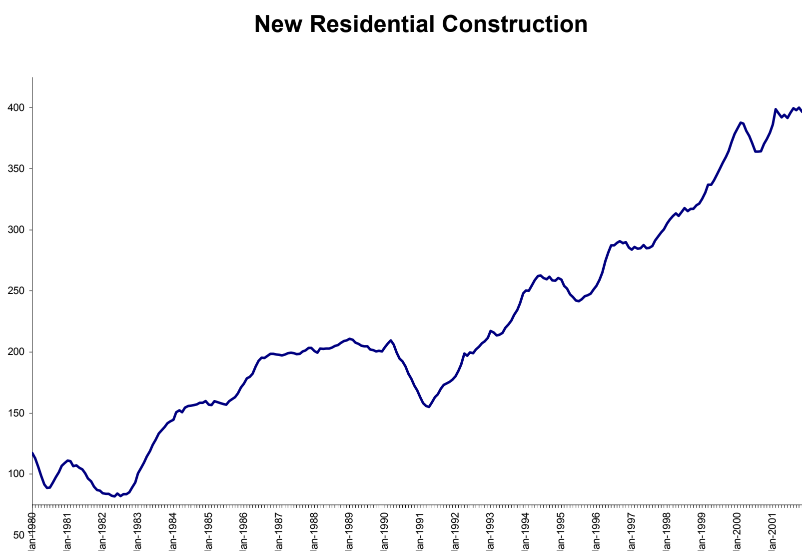
Moreover, there is evidence to suggest that **the housing wealth effect may be significantly larger than the stock market wealth effect** we've become so obsessed with.

Based on a recent study by Robert Shiller (of "Irrational Exuberance" fame) housing has *always* been a more important driver for consumers than the stock market. In his rigorous state-by-state and 14 country analysis, he found housing to have TWICE the correlation with consumption than the stock market has.

So, with housing in the driver's seat of the great consumption rig, it bears considering what the future holds for the sector.

As to the **demand side**, it's essentially a factor of employment and demographics. Given the remarkable strength in employment, it's hard to envision it getting much better from here. And household formations, having peaked in 1998 and are headed steadily downward as the baby-boom bulge moves into retirement. So, the outlook for demand **would appear to be stagnant, at best.**

Meanwhile, the **supply picture looks considerably less favorable**. Like the real estate boom of the mid-1980s, the recent run up in prices has invited an **enormous amount of new construction**.



Some of this new supply is already being reflected in the Inventory of Unsold Homes, which has started to trend higher.

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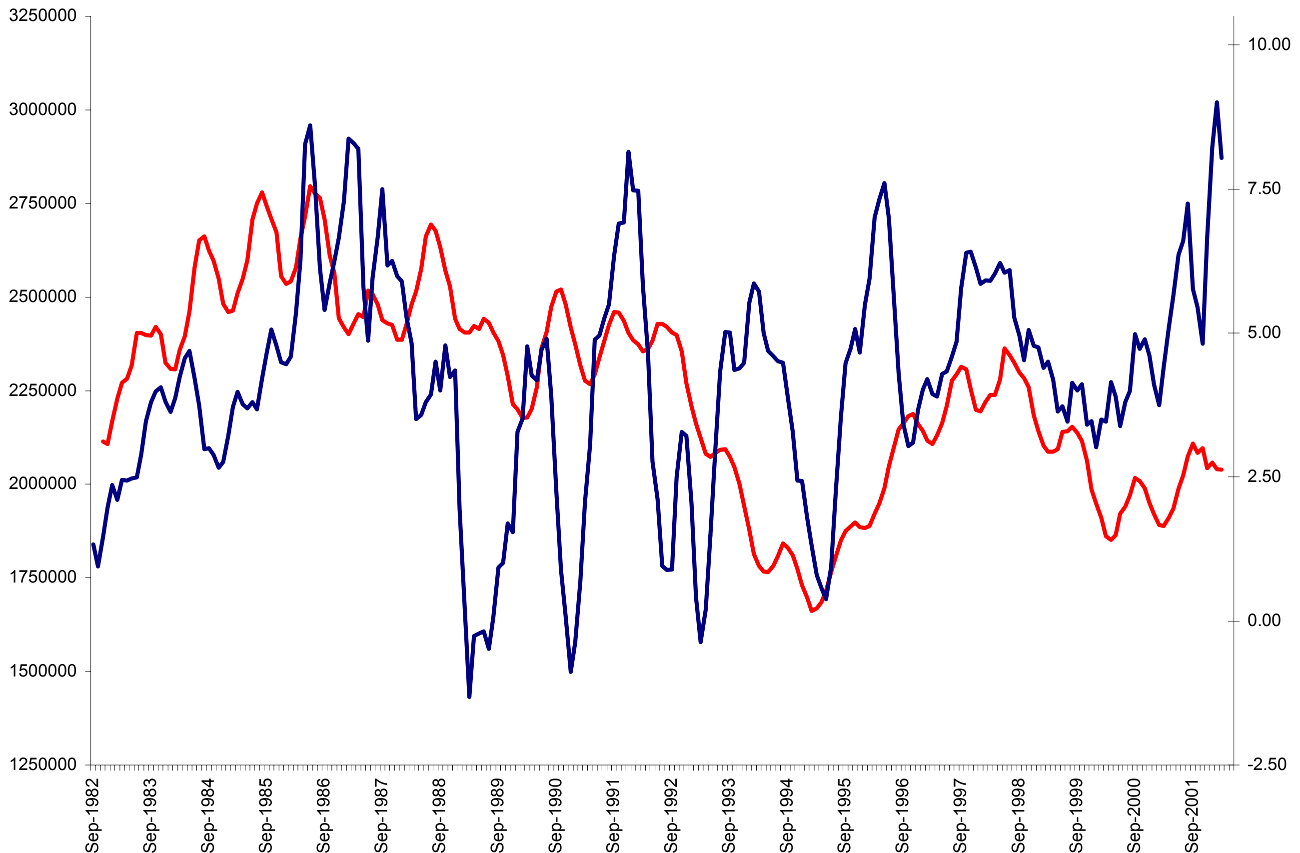
With all this supply coming on, it's just a matter of time before prices get smacked…

Inventory of Unsold Homes vs. Median Home Price



And this is where things get ugly…

With homeowners' equity near all-time lows, any softening in home prices could engender the risk of a cascade into negative equity.

But even more immediately, **the increase in mortgage debt service** (again, despite new lows in mortgage rates) **does not bode well for consumption as the Fed prepares to reverse course.**

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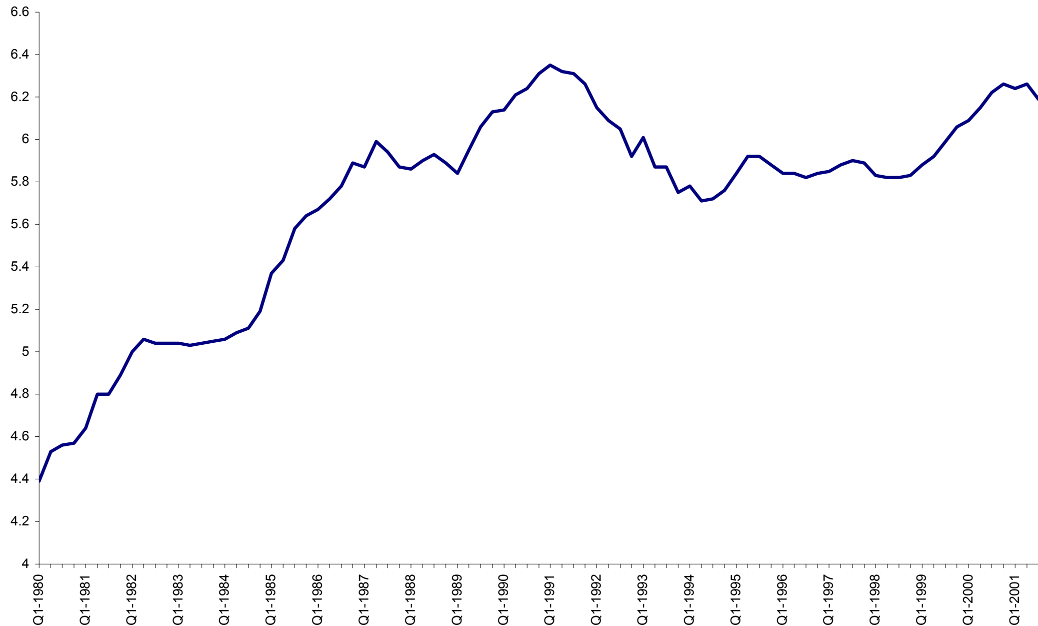
Mortgage Debt Service % DPI



LET'S TWIST AGAIN… ?

Aware that the underpinnings of the current recovery are rooted in this housing bubble, Greenspan will surely make no haste in raising rates. But, should inflation pressures (like the recent increase in energy prices) force his hand, we would not be surprised, in fact **we would *expect* to see the Fed try to tinker with the shape of the yield curve** to keep mortgage rates down. (Like they did last winter in their coordinated 'Operation Twist' with Treasury).

In light of the recent revelation that the Fed discussed employing 'unconventional measures', should their standard tools be rendered impotent, we must surely be alert to what they may be doing behind the curtain.