Professor Piggington's San Diego Real-Estate Chrono-Collapsometer

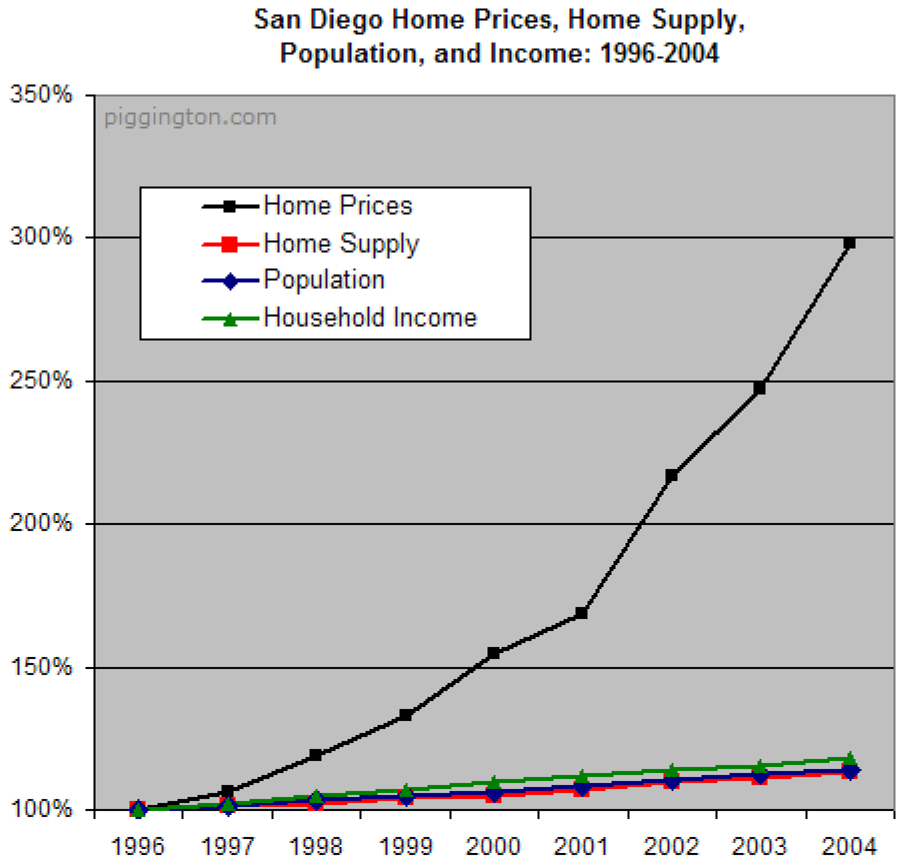
A Brief Defense of the Premise

As stated in the Introduction to the Econo-Almanac, this site is not focused on convincing anyone that there is a speculative mania occurring in San Diego residential real estate. The evidence for this conclusion is so ample that there is no need to waste the Chrono-Collapsometer's precious calculating cycles on the analysis thereof.

Nonetheless, we have prepared a brief primer for those who are unfamiliar with the goings-on in America's Finest (and Least Affordable) City.

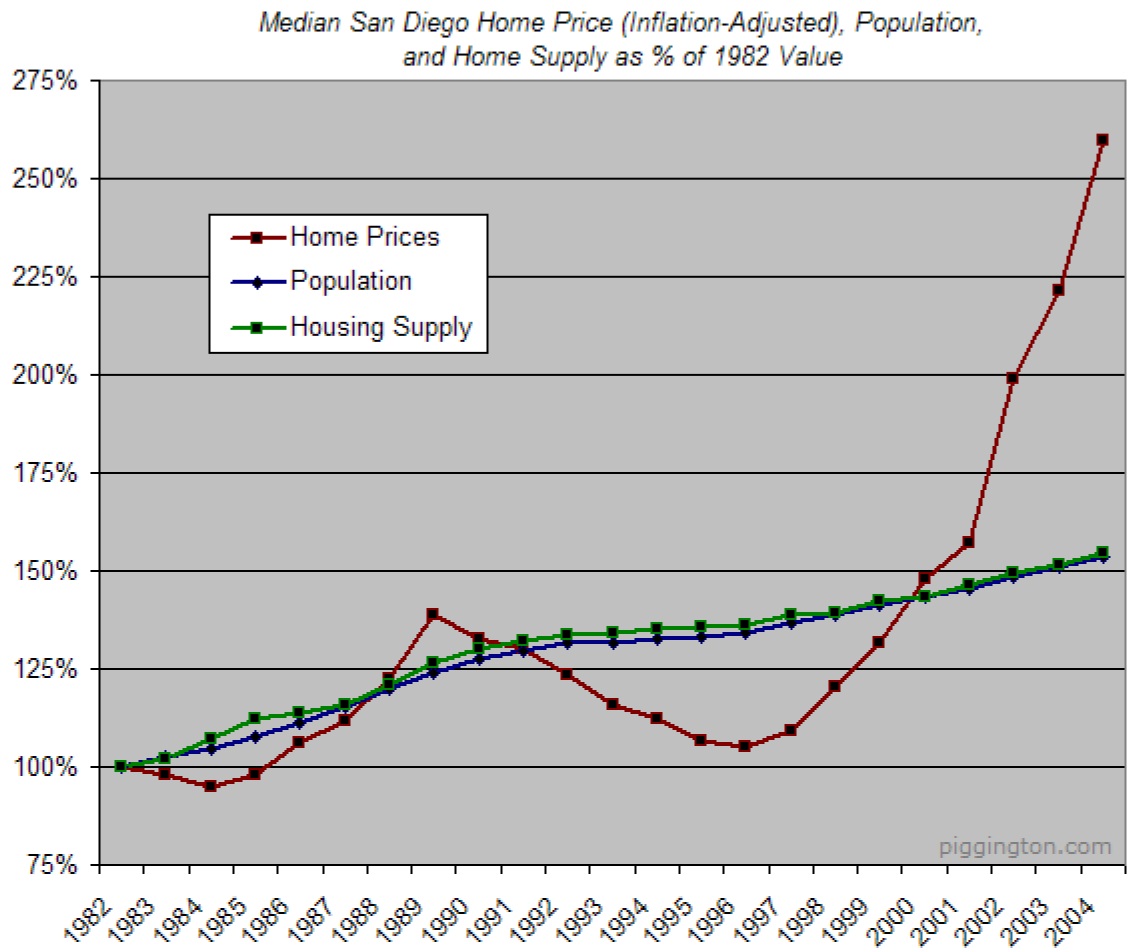
Conventional wisdom goes that San Diego is experiencing a severe housing shortage with no end in sight. There is no mania; rather, the runup in prices is appropriate due to the supply and demand imbalance caused by a lack of developable land, years of underbuilding, and a huge surge in population due to San Diego's desirability as a place to live. Adding fuel to the fire is the fact that San Diego's wealth has grown significantly due to the biotech and wireless industries.

While there is some spurious logic in the above reasoning (for instance, wasn't San Diego weather nice 10 years ago, when housing cost 1/3 as much?), for the most part it sounds reasonable on paper. There's only one problem: as often as the above hypothesis is repeated by amateur and professional alike, nobody ever bothers to check whether the underlying assumptions are actually true. A while back we set out to do just that, and were pretty surprised at what we found:



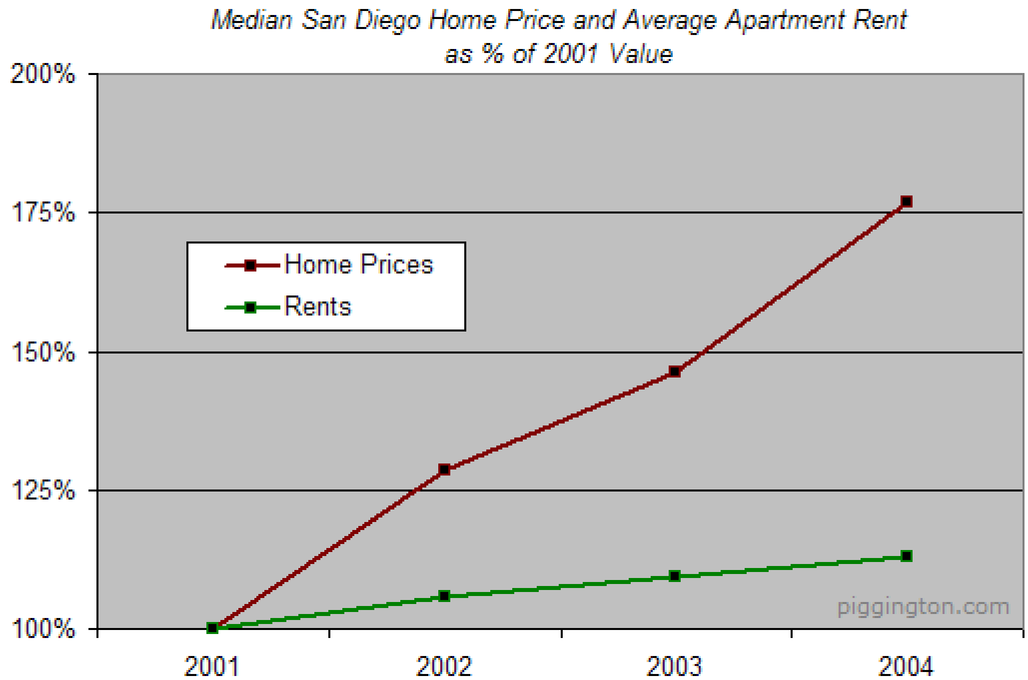
Since 1996, there has been no surge in population. And the growth in population has been matched exactly by a growth in the supply of housing units. Household income has barely kept pace with inflation. During this time, the median home price tripled.

We grew suspicious. So we looked a little further back. Lacking local income figures going further back than 1992, we instead used inflation-adjusted home prices. Adjusting the prices for inflation reflects how much San Diegans have been willing to pay for homes in relation to other goods. Also, since wages tend to track inflation, it gives a rough idea of how much they have been willing to pay in relation to income.



What we saw is that ever since a slowdown in the early-90's bust, population and housing supply have grown in line with historical growth rates. We also saw that the inflation-adjusted median home price is astonishingly high, making the peak of the late-80's real estate bubble seem insignificant by comparison.

Another way we looked at the "real" value of homes was by how much rental income they could generate. This is a good method because it abstracts out consideration of population or income growth. If the population surges or gets really wealthy, that should be reflected in the cost of both renting and owning a place to live. As the following graph shows, home prices have grown 6 times as fast as rents since home prices started surging in 2001:



All evidence pointed to the same conclusion: that the meteoric rise of San Diego home prices is not remotely justified by fundamentals. The vaunted "shortage" has nothing to do with demographics and everything to do with the fact that everyone in San Diego, fearful of being priced out of the market, desperately wants to get in on the housing gravy train. The so-called shortage is no different than the "shortage" of amazon.com stock in 1999--there were a lot of eager buyers and not enough sellers--but then, as now, the actual value of the asset being bought was not taken into consideration.

Common Objections

The shortage hypothesis, while the most ubiquitous argument to the idea that prices must come down, is not the only one. Other common objections, along with our brief counterpoints, follow:

- "This couldn't be a speculative bubble because not that many people are flipping properties or buying rental properties."

  We take issue with this definition of "speculation." Most people who are buying right now are stretching themselves to the limit (as evinced by the pervasiveness of interest only/negative amortization/no down payment/etc loans) to buy a house. These people are almost without exception speculating that real estate will go up. (More here.)

  As is the case as in all speculative bubbles, expectations for future gains are completely unrealistic. During the 20 years prior to the bubble's onset in 2001, San Diego's median home price increased by an average of 5.5% per year. Given that homes are so expensive, people should expect them to appreciate at *less* than the average historical rate, not more. But in 2002 economist Robert Shiller asked new homeowners in Orange County, CA (sorry, no San Diego data but OC is close by) how much they thought their home prices would increase annually over the next 10 years, and the mean response was **13%**! That's 13% per year, compounded every year for the next decade, starting from an already very high base in 2002. Good thing this isn't a speculative mania.

- "It's better to own and be building equity than to pay your landlord's mortgage."

This objection completely disregards the carrying costs of one's mortgage. The majority of monthly payment (or all of the monthly payment, in some cases) goes towards interest, which is not building equity. Since you can deduct mortgage interest from your taxes, it's usually beneficial to own and pay a mortgage over renting. But if prices are high enough, even with the tax deduction you will pay more in mortgage interest than you would in rent for the equivalent place, in addition to paying property tax.

The last condo we were living in was sold in April 2004. At that time, we calculated that the carrying costs of ownership--including tax deductions--would be twice as much as we were paying in rent. In other words, we were building a lot of equity by saving money and putting it in the bank. Of course, equity can also be built by home prices rising. Please see the above bullet.

- "People need somewhere to live."

  Yes, just as they did 10 years ago when homes cost 1/3 what they do now. This argument is effectively saying "homes can't go down," an assertion which has been proved wrong many times in the past.

- "If homes were overvalued, people wouldn't be buying them."

  As weak an argument as this seems, we saw it just yesterday in a local newspaper and felt compelled to include it. The debater is apparently a proponent of Efficient Market Theory, which holds that the price of an asset is the sum of all knowledge of all investors, so it can't ever be wrong. Proponents of Efficient Market Theory, while a somewhat endangered species today, were readily spotted as late as February 2000 at Pets.com shareholders' meetings.

- "It takes a local recession and local job losses to drive down home prices."

  Quoting from an entry already written:

  People think that, because the last housing bust in SD (early 90s) was caused by a local recession with attendant out-migration and unemployment, that a housing bust can only be caused by job losses. This is absurd. To these people, the median price of a home could go up to $10 million, and they'd still think everything was fine as long as job growth continued.

  In reality, there is an upper limit to how sustainably expensive housing can be in comparison to incomes. We've long since passed that limit.

  Consider also that 50% of San Diego's job growth over the past three years has been related to the housing industry. This time around, a housing slowdown could cause a recession instead of vice-versa.

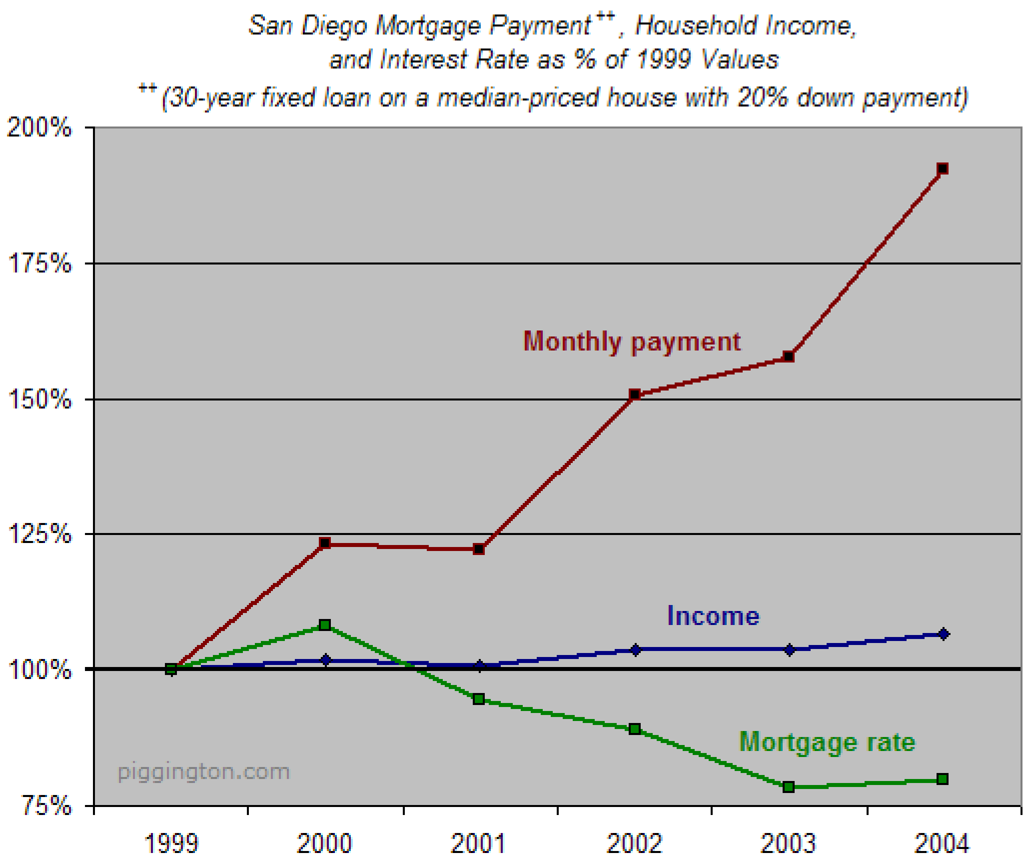
- "Prices may flatten out for a while but they won't go down."

  This may have been true a couple years ago, but at this point home prices are so out of scale with wages and rents that there is no way that inflation can catch incomes up to prices in any reasonable amount of time. This is a very complicated topic on which we have already written a longwinded essay.

  This argument also ignores the fact that, like all end-stage bubbles, the real estate market is only being kept alive at this point by its continued appreciation. If prices were to flatten out, it would significantly reduce the mad rush to get into the appreciation gravy train. And keep in mind that the only thing that enables many San Diegans to pay their massive mortgages and still stay solvent is the income they get from cash-out refis on their ever-appreciating homes. Once home prices stop appreciating and this source of income dries up, the market will be rendered truly unaffordable and will have to drop.

- "Interest rates are low so while prices may be high, monthly payments aren't that historically high."

  This argument actually has some validity. However, even as interest rates have dropped, monthly payments have far outgrown incomes:



  More importantly, though, this argument is unconvincing because it acknowledges that if interest rates go up there would be trouble. This is a very real possibility: the Fed and the Asian Central Banks have manipulated the bond market to keep rates low, but these types of market manipulations never last. Interest rates will go up--maybe a lot. Interest rate manipulation is briefly discussed in the aforementioned longwinded essay on potential home price drops. We have also written an article on the effect of rising rates over at Financial Sense Online.

- "The housing market isn't like the stock market--people can't just dump and run."

  Agreed. Notwithstanding a severe interest rate spike, housing would never "crash" over a short period like stocks. Real estate market moves take years: the last bust took 5 years to get from peak to trough. It may take a while, but prices will return to long-term trend, just as they always do.

- "Real estate always goes up in the long run."

Agreed. It is not our advice that everyone burn their houses down for the insurance money and run to the hills. It is perfectly appropriate to own a home as long as you can afford it and aren't planning on selling it within the next 5-10 years.

- "People have been talking about a real estate bubble for over a year, but prices have continued to go up."

  Yes, prices have gone up. That's what happens in a speculative bubble. To quote The Economist: "The first rule of bubbles is that they always go on longer than one would think possible. The second rule is that they always burst."

Recommended Reading

For those seeking background above and beyond ill-edited pseudo-Victorian prattle, we recommend two books. Both are very quick and entertaining reads.

- "A Short History of Financial Euphoria" by John Kenneth Galbraith. This is an overview of patterns that have emerged throughout history's many speculative bubbles. San Diegans will find much that is familiar.

- "How to Profit from the Coming Real Estate Bust" by John Rubino. Despite the rather sensationalist title (which we assume was forced upon the author by his opportunistic publisher) this is a very level-headed account of the dynamics at play in today's housing market. It includes information on the GSEs, the Fed, interest rates, and all kinds of subjects that are vital for today's homeowner to understand. It also contains investment advice for those inclined to profiteering.