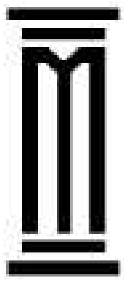

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POLICY BRIEF

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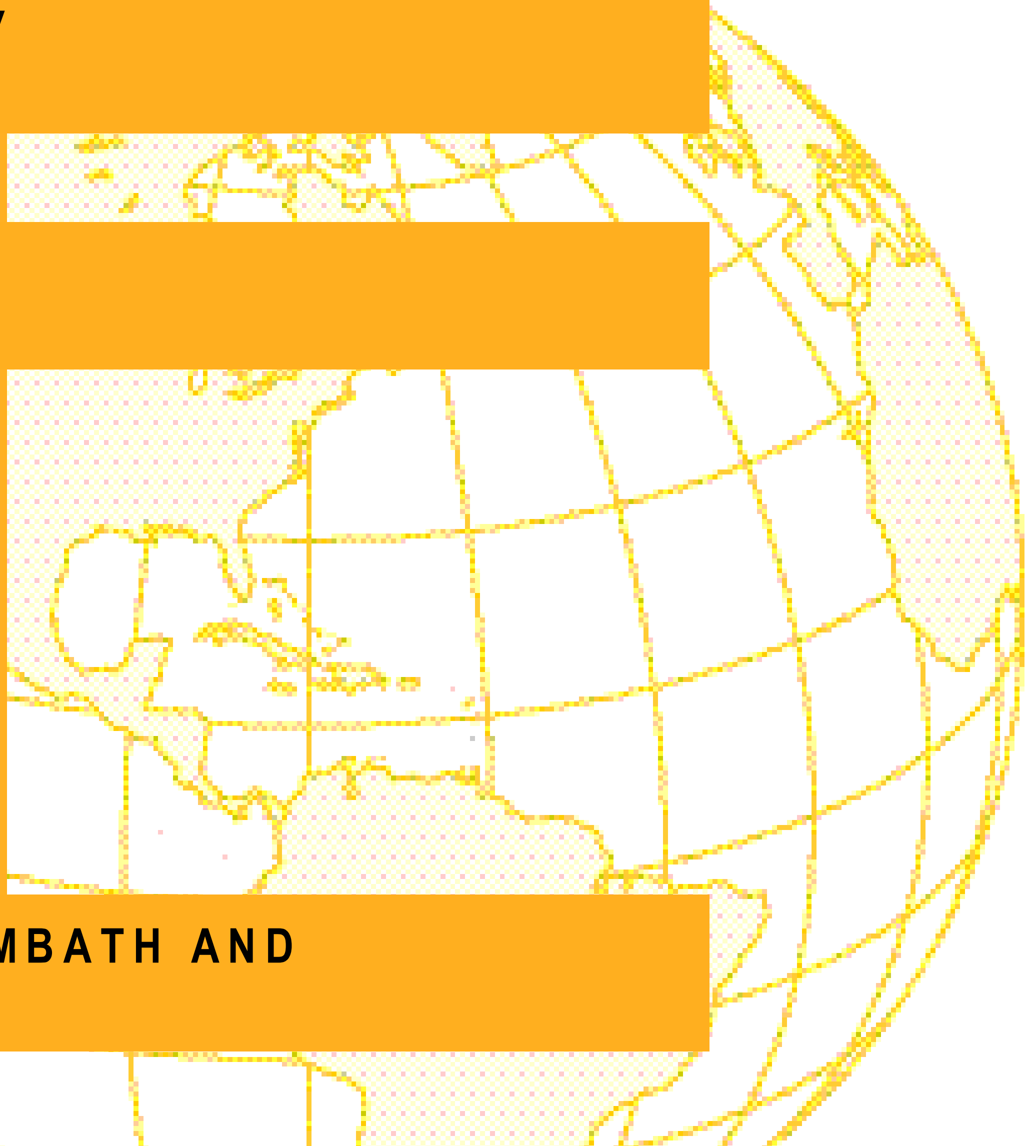
## INVESTMENT IN HOUSING IN TIMES OF ECONOMIC UNCERTAINTY

June 2002

Number 30



BY SUSANNE TRIMBATH AND JUAN MONTOYA

# A NEW KIND OF GOLD?
## INVESTMENT IN HOUSING IN TIMES OF ECONOMIC UNCERTAINTY

June 2002

**By Susanne Trimbath and Juan Montoya**

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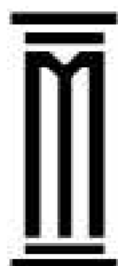

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## Executive Summary

Since the 1960s, Americans have looked to the stock market for investments; residential real estate was just a place to live. No more. Much like gold in the 1970s, Americans now appear to be treating the purchase of residential real estate as the investment of choice in times of economic uncertainty. This paper discusses two reasons for this major behavioral change.

First, real estate has become the *psychological equivalent* of gold, the asset considered most tangible and therefore, rationally or not, the safest. Second, the timing of the shift in real estate investment patterns suggests that the change is a side effect of the stimulative monetary policy used during economic recessions. Reduced interest rates encourage investment in real estate by making it more affordable.

## Introduction

The Capital Studies Group at the Milken Institute routinely examines diverse financial markets, including banks, stock markets and bond markets.[1] Recently, we looked at an asset class that is, of late, receiving a great deal of attention: real estate. This report examines data on the real estate holdings of households.

In the post-war boom, the value of *both* real estate and corporate equity rose together in dollar terms. Beginning in 1980, however, the dollar value of real estate moved in directions *opposite* to stock market capitalization. This paper demonstrates the relationship between the real estate investments of households and economic uncertainty before moving on to explain why the pattern of household investment in real estate has changed in the past 20 years.

Valued at over $23 trillion, residential real estate is one of the main asset categories in the U.S., easily surpassing the $11 trillion market value of all New York Stock Exchange listed stocks, the $6.9 trillion in assets held by commercial banks and the $10 trillion value of the country's annual economic output (Figure 1).

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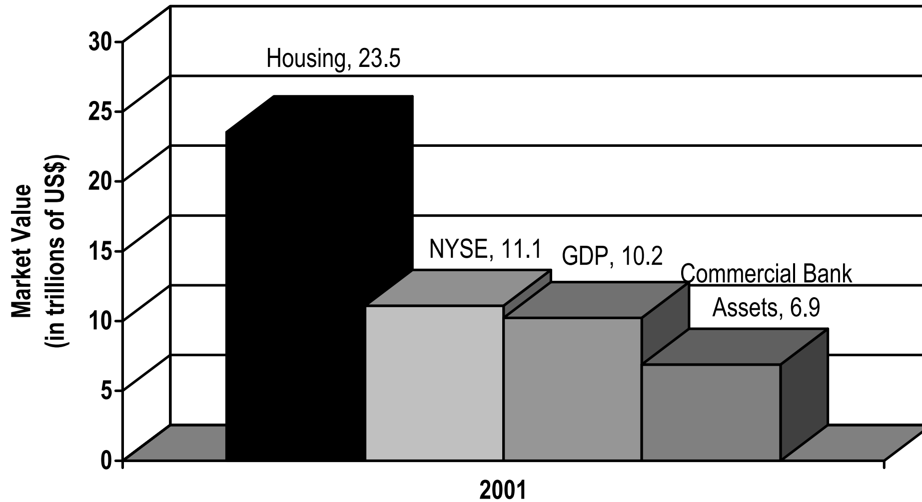
[1] See "Institute View" in *Milken Institute Review*, Second Quarter, 2002.

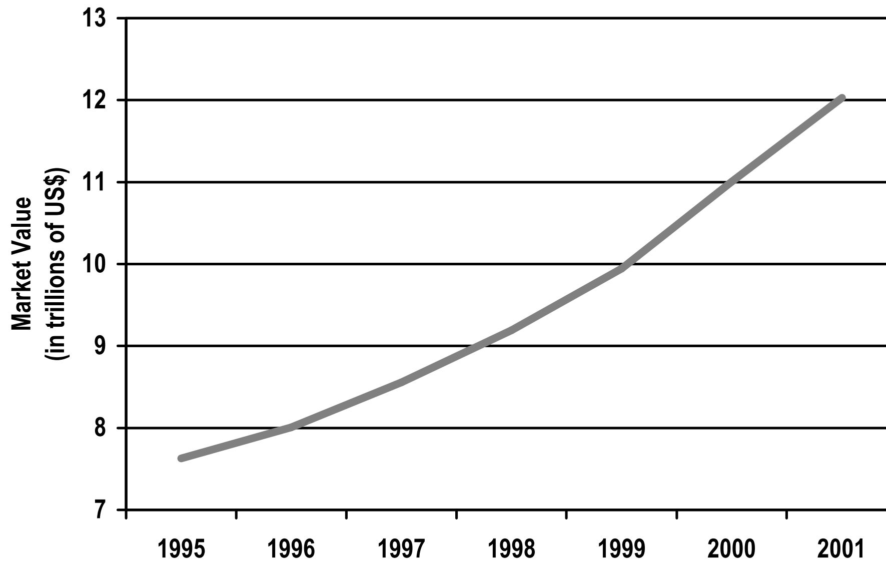
**Figure 1: Size of the Market for Real Estate**




Source: Milken Institute

Of the $23.5 trillion invested in residential real estate in the U.S., the household sector is by far the primary owner, with more than $11 trillion of housing on its balance sheet. Driven by both strong price appreciation on existing homes and a very active market for new homes, the value of residential real estate has increased at a rate of more than $1 trillion a year since 1999 (Figure 2).

**Figure 2: Growth in the Value of Household-owned Real Estate**

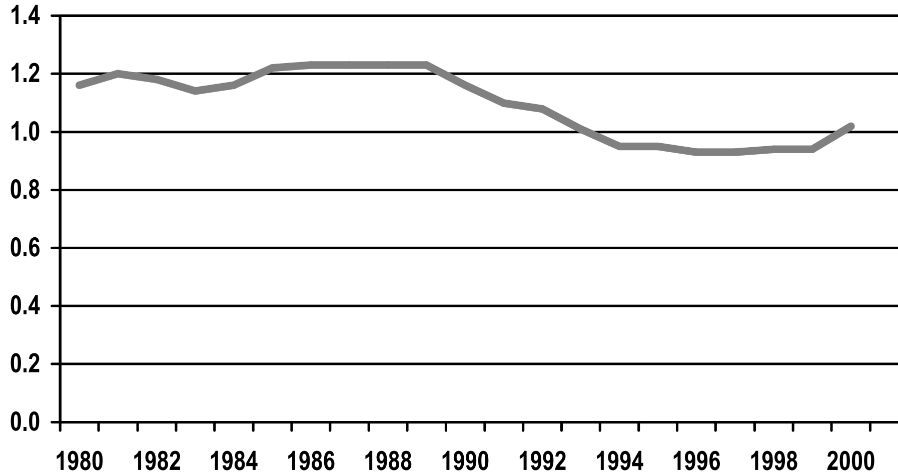



Source: Federal Reserve

***Housing Investment and Economic Uncertainty***

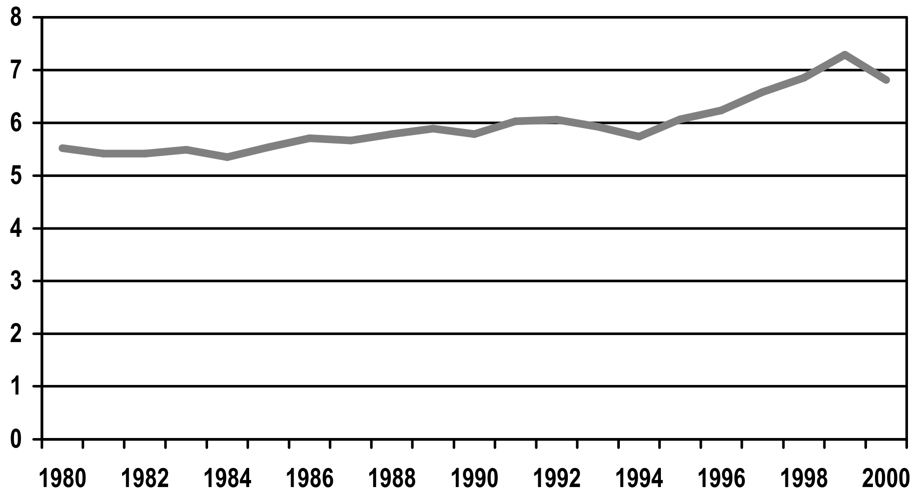
Looking at household income ratios across time we see the initial evidence of the change in investment habits. From 1980 until about 1989, both real estate equity and total net worth increased, albeit slowly, as a percent of income. A comparison of Figure 3 and Figure 4 reveals somewhat similar patterns: real estate investments rose with overall household investment. However, starting around 1990, the two ratios begin to diverge. Real estate equity falls almost every year from 1990 to 1999 while household net worth rises. In the last observation in the series (2000) real estate equity rises and net worth falls. Except for the nine months from July 1990 to March 1991, the U.S. economy was in constant expansion while the ratio of real estate equity to household income was falling. As the most recent economic recession began to take hold, that ratio begins to rise again.

**Figure 3. Ratio of Household Equity in Real Estate to Income**




Source: Milken Institute (Federal Reserve, Bureau of Labor Statistics)

**Figure 4. Ratio of Household Net Worth to Income**



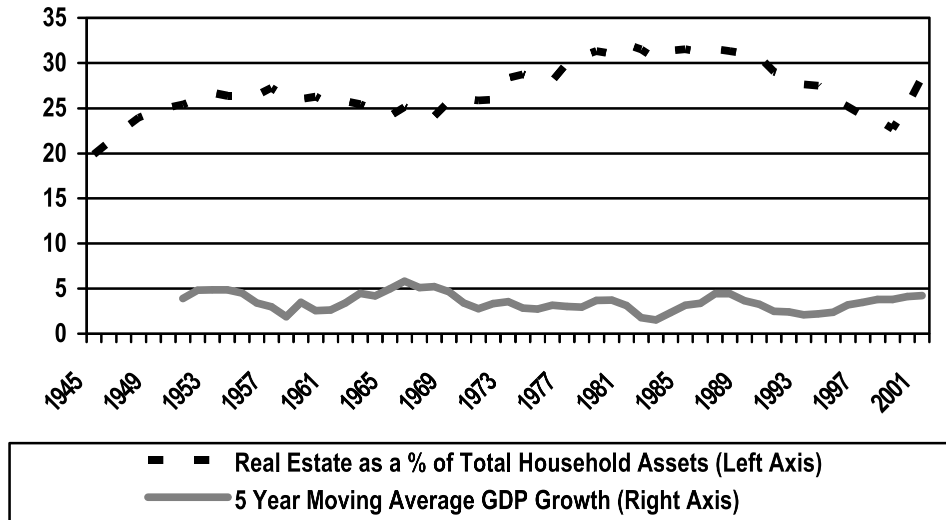

Source: Milken Institute (Federal Reserve, Bureau of Labor Statistics)

***Slow Economic Growth with Rising Real Estate Investment***

Household reliance on home ownership for wealth peaked in 1981 (Figure 5). It is at this point that we begin to see a change in the correlation between economic uncertainty and household investment in real estate. There is a weak but significant correlation between low GDP growth and a high share of real estate assets in household financial investments.

The level of GDP is positively correlated with real estate's share of household investment from 1945 to 1980 (0.81) and negatively related after that (-0.92), indicating an about-face in the relationship.

**Figure 5: Slow Economic Growth and Increased Investment in Real Estate**

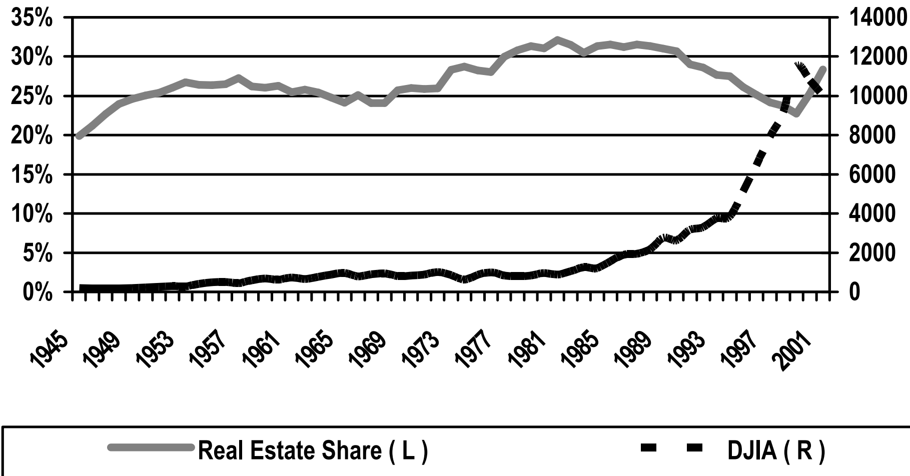



Source: Milken Institute, NBER

***Weak Stocks, Strong Real Estate***

The relatively steady decline in housing's share of wealth occurs simultaneously with the 1990s stock market expansion. This relationship also demonstrates a turnaround in 1980 (Figure 6). The correlation coefficient of the Dow with real estate's share of household investment is positive from 1945 to 1980 (0.48) and negative from 1980 to 2001 (-0.90).

**Figure 6. Real Estate's Share Driven by More than Stock Values**

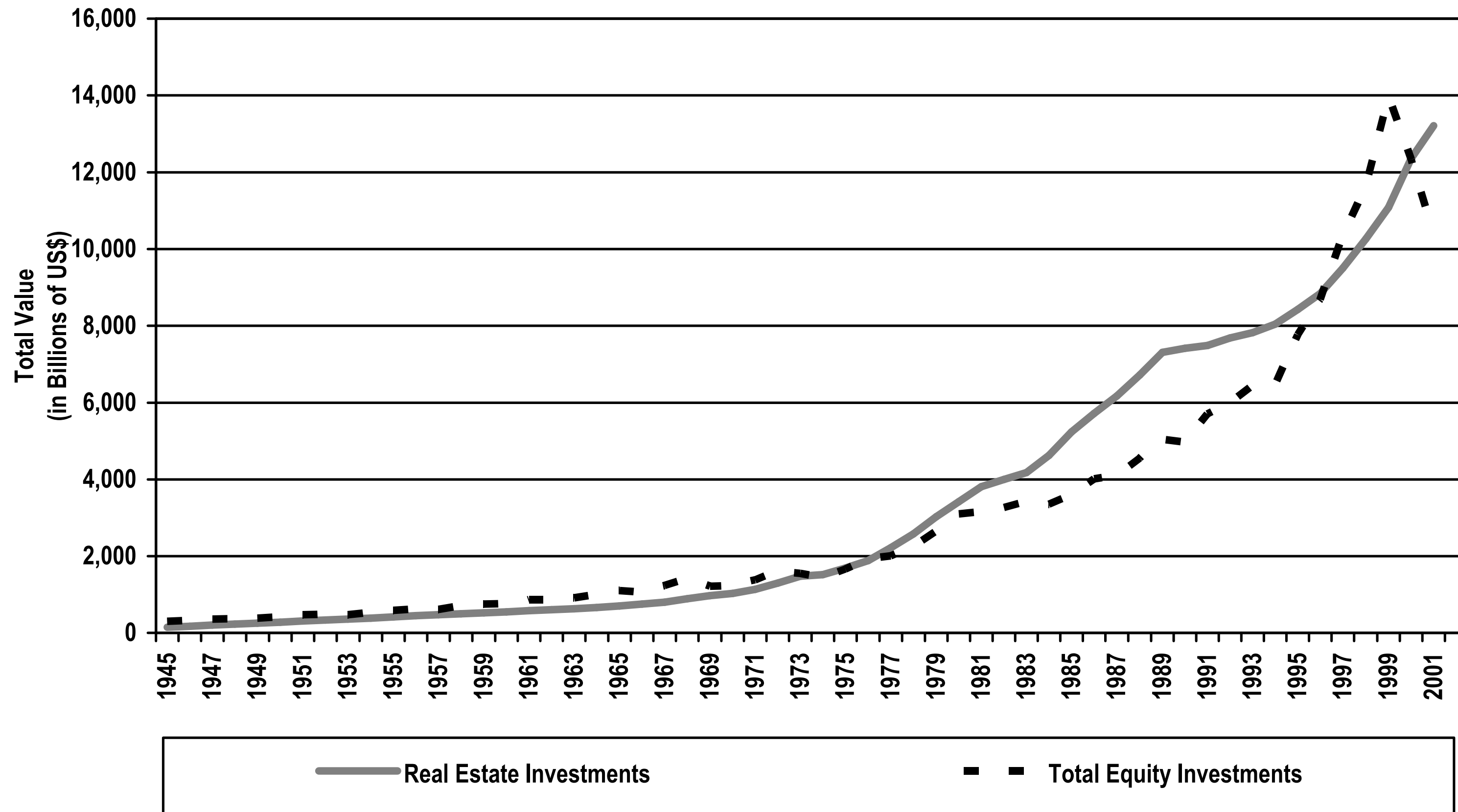



Source: Federal Reserve, Bloomberg

In the 1960s, households moved their financial investments into the securities markets, reducing real estate's share of household assets. The low point occurred in 1968, with real estate falling to just 24 percent of household assets. This trend began to change in the late 1970s, a time of great financial uncertainty for many households.[2] Peak household reliance on home ownership for wealth occurred in 1981 at 32 percent. By 1999, after nearly ten years of economic expansion, real estate was down to just under 23 percent of household assets, a level not seen since 1947. In absolute terms, however, beginning in 1980, household investments in real estate significantly exceeded investments in businesses.[3] Except for the five years from 1996 to 2000, real estate has dominated household investment since (Figure 7).

[2] The late 1970s economic expansion was preceded by a 16-month contraction that saw price controls, oil shocks, wage freezes and the Viet Nam War. Oil prices went from $4/barrel in 1973 to $33/barrel by 1979.
[3] The first year that real estate exceeds business investment is 1974. From 1996 to 2000, household investment in business again exceeds real estate investment, despite the 1997 increase in home values. The asset allocation story of real estate investment will be the subject of additional research at the Milken Institute in the near future.

**Figure 7. Household Investment in Real Estate and Equities**




Sources: Federal Reserve, Flow of Funds

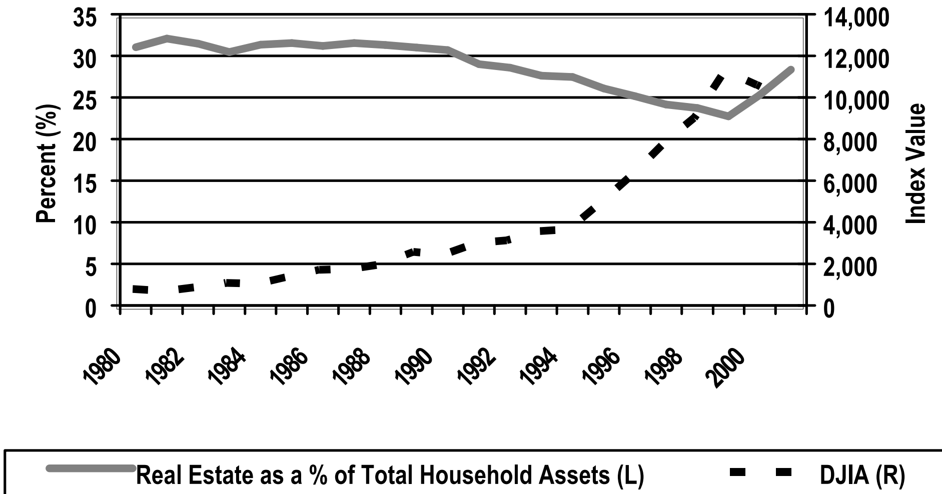
### ***Why Real Estate?***

The change that we are talking about might be misunderstood as a simple change in the *share* of investment (rather than the value) induced by increases in stock prices that drive up the value (and hence the share) of equity in household investment. We showed earlier that the increase in real estate investment can be seen in absolute terms, as well. However, the change is somewhat subtle. To illustrate how it might be missed by the casual observer, Figure 8 and Figure 9 show both real estate's share of household investment and the stock market, using 1980 as the break point. Rising equity prices seem to reduce real estate's share of household investment in recent data (Figure 8) but the relationship does not hold prior to 1980 (Figure 9).

Contrary to popular opinion, a plunge in the stock market doesn't necessarily translate into a change in the value of residential real estate. Economists generally agree that stock gains do not greatly affect real estate values outside New York, where Wall Street money drives home prices. A modest stock market decline could actually help the housing boom. Falling stock prices may ease pressure on the Federal Reserve to raise interest rates "helping the good times last a little longer."[4] For this to be true, we need to see whether real estate investments are sensitive to interest rate changes.

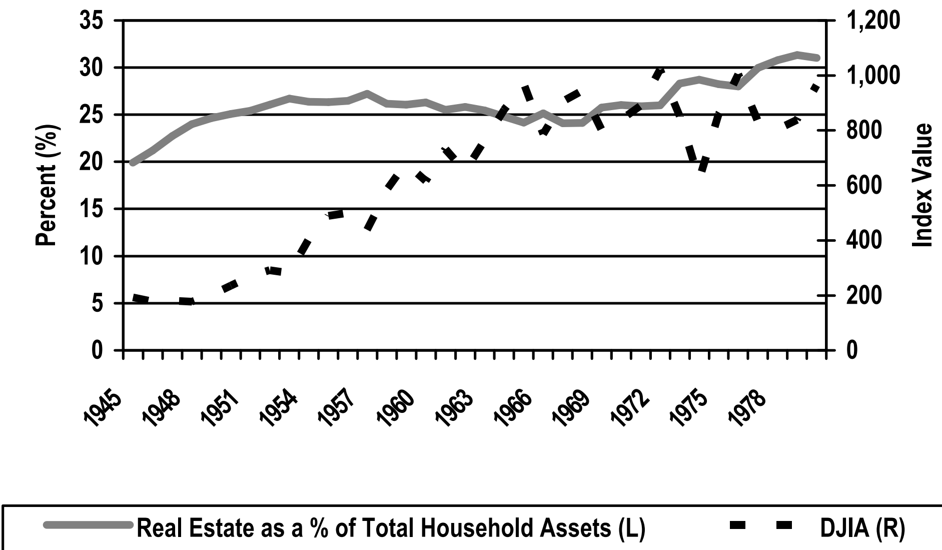
[4] Fannie Mae chief economist David Berson quoted in Newsweek, August 9, 1999.

**Figure 8. Rising equity prices seem to reduce real estate's share of household investment**




Sources: Federal Reserve, Bloomberg

**Figure 9. But the relationship does not hold prior to 1980**

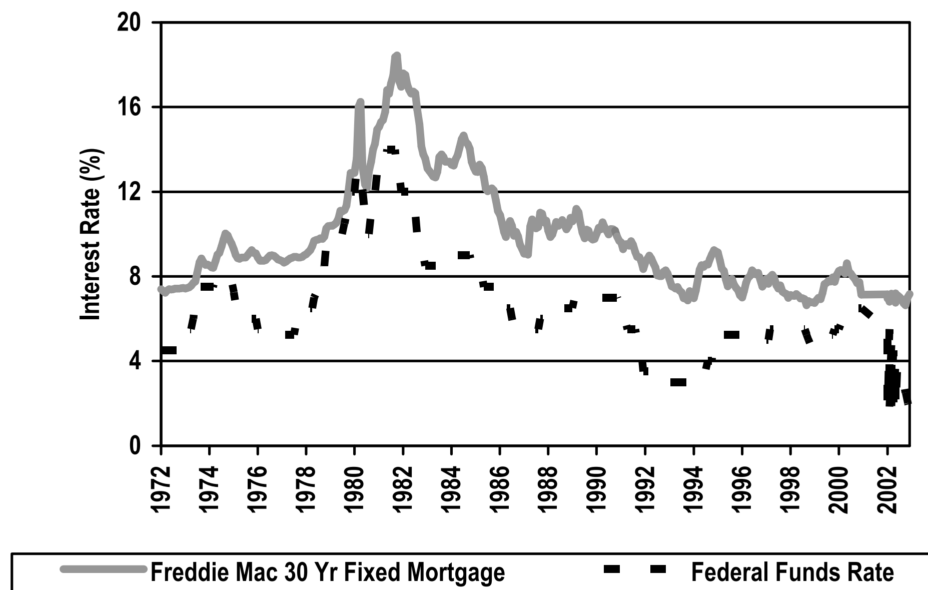



Sources: Federal Reserve, Bloomberg

*Interest Rates*

We believe that there are valid theoretical reasons for accepting 1980 as the turning point beyond which rising equity prices no longer reduced real estate's share of household investment. Interest rates became more market sensitive after passage of the Depository Institutions Deregulation and Monetary Control Act. The Federal Reserve moved away from targeting interest rates as a mean of implementing monetary policy beginning in late 1979.[5] Instead, the federal funds rate was determined as the result of market forces. Because of this, mortgage rates rose and fell more consistently in response to U.S. economic conditions, making real estate more affordable under the relaxed monetary policy seen during economic downturns (Figure 10).

**Figure 10. Federal Reserve Policy and Mortgage Interest Rates**




Sources: Federal Reserve, Freddie Mac

Most recently, in an attempt to prevent the slowdown of the economy even before the events of September 11, the Federal Reserve lowered the benchmark discount rate, which allowed lenders to keep mortgage rates at levels reminiscent of 1972. Spurred by lower

[5] Instead, the Federal Reserve targeted the money supply as its tool for monetary policy. Changes in the money supply affect interest rates indirectly. The federal funds rate target once again became a means of implementing monetary policy in the late 1980s.

interest rates, apartment renters saw mortgage payments drop to levels close to monthly lease payments, making homeownership not only a possibility but also a smart financial decision.

As interest rates dropped and housing became more affordable, the difference between rising rents and decreasing mortgage payments induced more and more would be apartment renters to become homeowners. In other words, as higher mortgage payments come down and lower rent payments go up, the difference between them all but disappears. As the two meet or cross, homeownership comes within reach of a renter's monthly budget.[6]

It is common for new mortgages to cover 80 percent or more of the value of a home. Yet, mortgages account for only 44 percent of the value of residential real estate. The average homeowner, therefore, is not extraordinarily burdened by his mortgage. The important fact here is that real estate ownership is very highly leveraged, making it more sensitive to interest rate changes than other investments (for example, corporate equity investments). Beyond the tax benefits afforded homeownership financed with debt, the use of leverage raises the return on capital for residential real estate investments beyond mere price appreciation. The earning power of leverage combined with the insurability of property presents an investment that is hard to beat.

### *A Golden Substitute*

The role of gold as a hedge against inflation and economic uncertainty has changed, too. Historically, investment in gold rose with economic uncertainty. However, after September 11 for example, gold barely moved. Some are comparing the long term outlook for gold to the fate of silver. A century ago, silver was used as a monetary standard, a status that gave the metal more than its intrinsic value. When that status was removed, the price lost its luster along with the metal. Gold continues to play a role as a monetary standard, but the actions of central banks to manipulate supply have modified much of its reactive nature. Gold's price now appears to follow that of other commodities,

[6] Additional research at the Milken Institute will explore this topic in more detail in the near future.

like a simple alternative investment, rather than to serve a more important purpose of providing security during times of economic uncertainty.

In a 1974 Forbes article, “A New Kind Of Gold?” from which we borrow our title, the newly elected President of Venezuela, Carlos Andres Perez, was quoted as saying “As gold disappears as the governing pattern of world monetary arrangements, oil is tending to take its place.”[7] As central banks became more willing to manipulate the supply of gold through reserve actions, gold’s status declined. In the 1970s, gold offered a secure store of value during inflationary times. During times of economic uncertainty, investors seek assets that “feel” secure. Real estate has replaced gold as the “feel good” investment because it is literally as solid as the ground upon which we stand. Unlike business equity, real estate is a high-touch investment.

As further evidence of increasing uncertainty, rates of return on a variety of assets recently examined by the Bank for International Settlements (BIS), moved relatively close together from 1992 to 1995, after which they began to diverge. It attributes worldwide turmoil in asset markets in the industrialized world to changing attitudes toward risk. The 1998 BIS Annual Report, for example, described a departure from normal pricing relationships resulting in asset prices that could not be explained by historical standards. It is plausible that these changing attitudes toward risk are affecting investment decisions in risky times, substituting real estate for gold as the tangible asset of choice for security in uncertain economic times.

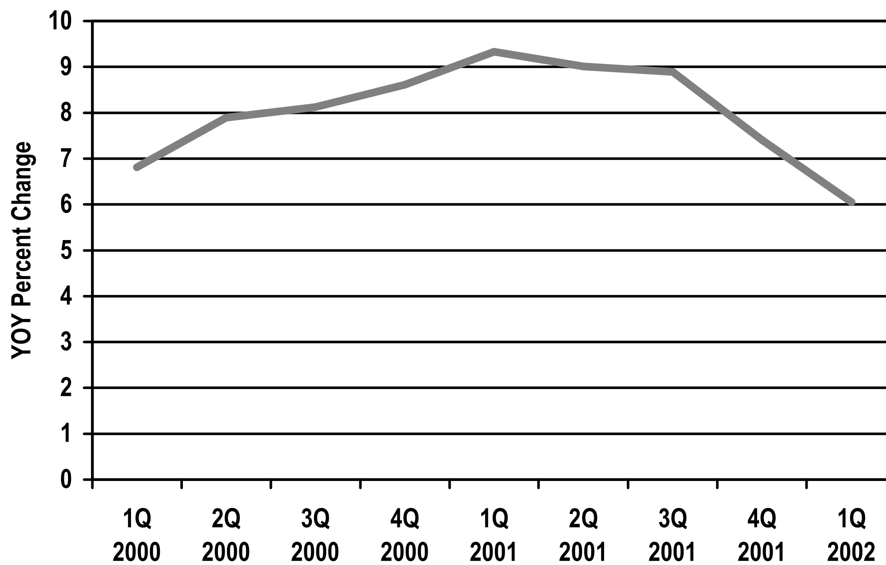
### *A Rational Investment for Timid Investors*

Residential real estate has two major advantages over most other investments: it is highly leveraged and fully insurable. To be a gold substitute, an investment must hold its value against inflation and not lose value during recessions. The performance of real estate investment has been quite good even before leverage is taken into account. On average, house prices increased by a compound annual rate of 5.6 percent over the past 25 years.

[7] Forbes, February 1, 1974, page 44.

As individuals became homeowners, the demand for new and existing homes grew faster than supply, creating an upward price pressure on homes, resulting in even stronger price appreciations over the past four to five years. According to the Office of Federal Housing Enterprise Oversight (OFHEO), house prices in the U.S. increased an average of 7.4 percent during the year 2001 alone.

**Figure 11: Year over Year Change in OFHEO House Price Index**




Source: Office of Federal Housing Enterprise Oversight, 2002

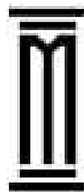
Real estate has also provided a moderate real rate of return historically. The House Price Index (HPI), published by OFHEO has risen at an average annual rate of 1.25 percent since 1975.[8] During the same period of time, the Dow has appreciated at a rate of 4.6 percent. The real return on investment for real estate is, of course, much higher because it is more highly leveraged and has tax advantages. Because residential real estate is fully insurable there is also a perception of protection against loss that is not found in the stock market, adding to the mystique of real estate as a new kind of gold.

[8] The index measures house prices adjusted for inflation.

## Conclusion

Although it is expected that homes will continue to appreciate in the near future, very high growth rates are unsustainable in the long run. (Figure 11 shows a recent slowdown in the home price appreciation rate.) Price appreciation rates should not greatly exceed general inflation rates. Influenced by higher prices, developers have been increasing the number of units they bring to the market, allowing for demand to be more readily satisfied. This reduces the price pressure on housing.

But don't expect a bust in housing prices, either. The comparisons to 1991 are irrelevant. That recession was a "credit crunch" recession; money simply was not available for anything, including home buying. The current recession comes with loose monetary policy, low interest rates and money available to finance home purchases. There is no evidence to suggest a 1991-type correction in housing prices this time around.



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