630-517-7756
www.ftportfolios.com

First Trust

Dec 15, 2009

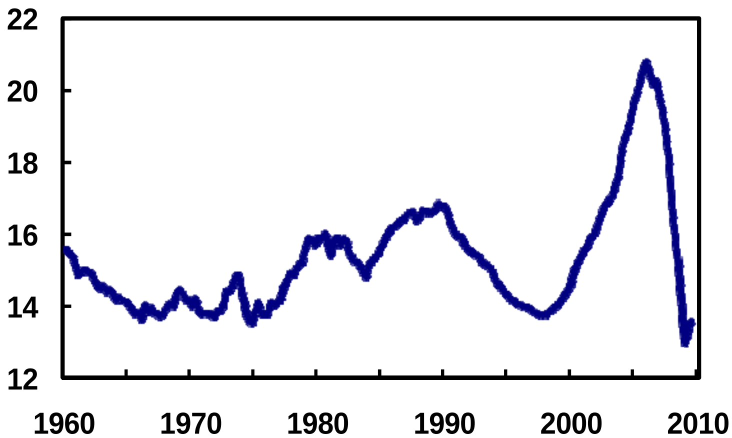
Economic Commentary

Dive In: Housing is Cheap

Last week the Federal Reserve released its *Flow of Funds* report – a quarterly report on household assets, debts, and net worth. Buoyed by a recovering stock market, household assets increased $2.7 trillion in the third quarter, bringing total gains in the past six months to $4.9 trillion. Meanwhile, households kept their debt in check. As a result, household net worth increased by an amount equal to the gain in assets.

The Fed's report also included some significant downward revisions to the market value of owner-occupied housing. This data shows that, on a national average basis, US home prices now appear to be *below* "fair value." This does not mean there will be no further declines in home prices. The states with the largest excess inventories (California, Arizona, Nevada, Florida, and Michigan) may see some price declines in the year ahead, but even in these states there are some better signs appearing. Outside of these states we expect a housing recovery and inflation to push prices higher.

Price-to-Rent Ratio

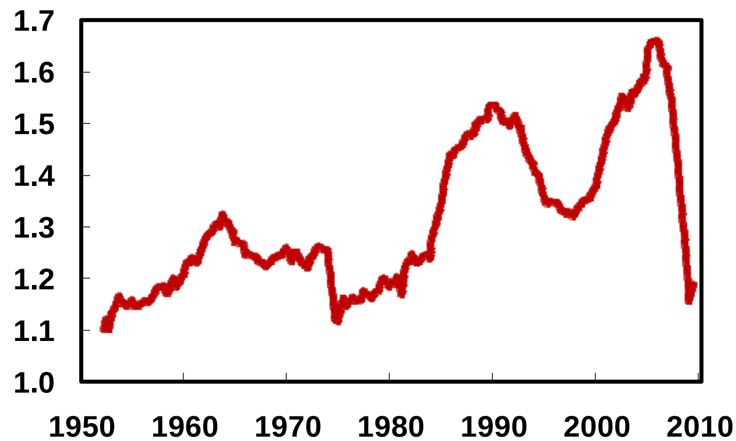


Source: Federal Reserve, Commerce Dept.

We assess fair value by comparing the Federal Reserve's figures on the market value of homes with government data on the rental value of homes. These numbers generate a "price-to-rent" ratio for the housing market. Normally, the P/R ratio hovers right around 15. For example, if a home rents for $1500/month (or $18,000/year), the home should have a market value of about $270,000 ($18,000 annual rent times 15).

At the peak of the housing boom, the P/R ratio hit 20.8, which meant a home renting at $1500/month had a market value of $375,000, almost 40% higher than fair value. With home prices down, in the first quarter of this year the P/R ratio had fallen all the way down to 13.0, the lowest on record (going back to 1959). In the third quarter, the P/R ratio was back up to 13.6, which means a house renting for $1500/month had a market value of $245,000.

Market-to-Replacement Ratio



Source: Federal Reserve

Another way to assess fair value is to compare the market value of homes with the cost of replacing them. Since 1952, on average, market value has been about 32% higher than replacement cost. This wedge is probably due to limits on new building, including the cost of obtaining the right to build, zoning rules, and environmental issues.

In late 2005, the market value of homes was 66% higher than replacement cost, an all-time high. However, in the second quarter of this year – the most recent period for which data are available – market value was only 19% higher than replacement cost. Both frameworks for assessing residential real estate prices – using rents and replacement costs – are saying the same thing: home prices are about 10% below fair value. Get ready for recovery.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*