First Trust
Monday Morning OUTLOOK
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No Housing Bubble

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Last week in the New York Times, Yale economist Robert Shiller wrote we are "experiencing one of the greatest housing booms in United States history." Given what happened in the aftermath of the last boom – a financial panic and the Great Recession – this will add to investors' fears about another recession lurking around the corner.

Shiller says that the national Case-Shiller (yes, the same Shiller!) home price index is up 53% since prices bottomed in the housing bust in February 2012 and are now 11% higher than they were at the peak of the boom in 2006. In his mind, these are both signs of a new bubble.

We have great respect for Shiller, who correctly called the internet stock market bubble in the late 1990s as well as the housing bubble in the 2000s.

However, there is a huge difference between housing today and where it was in the last bubble. To assess the "fair value" of homes, we use a Price-to-Rent (P/R) ratio. We get that by comparing the asset value of all owner-occupied housing (calculated by the Federal Reserve) to the "imputed" rental value of those homes (what owners could fetch for their homes if they rented, instead, as calculated by the Commerce Department). Think of it like a P/E ratio: the price of all owner-occupied homes compared to what those same homes would earn if they were rented.

For the past 60 years the P/R ratio has averaged 15.22. At the peak of the housing bubble in the previous decade, the ratio was 20.85, a record high. In other words, prices were 37% above fair value nationally, much more so in hot spots like Fort Myers, FL, Las Vegas, NV, and Scottsdale, AZ.

Then, during the housing bust, the ratio plunged to 12.96, the lowest on record. At that point, national average home prices were 15% lower than you'd expect given rents. Temporarily, that made sense: prices had to get well below fair value in order to clear the massive backlog of excess homes produced during the bubble.

Today, the P/R ratio is 15.81, so homes are only 4% above their long-term average relative to rents. That's well within the normal historical range and less than the typical transaction cost when a home is sold, and so no reason to sell.

Shiller is right that housing prices exceed where they were at the peak of the prior boom, but he's not adjusting for the rent those homes can earn. In the past twelve years, the asset value of owner-occupied homes is up 13% while imputed rent is up 45%.

Another reason to believe we're not in a bubble is that the pace of home building is substantially slower than during the previous bubble. Builders started 2.07 million homes in 2005 versus an annual need of about 1.50 million based on population growth and scrappage (teardowns, fires, floods, hurricanes,…etc.). So not only did homes get 37% overpriced, they did so when there were plenty of homes to go around. By contrast, this year builders will start about 1.25 million homes, below what we need to just meet population growth and scrappage.

Residential real estate is not in a bubble. Look for moderate price gains ahead, although with the gains tilted toward lower tax states due to tax reform.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-17 / 7:30 am	Empire State Mfg Index – Dec	20.0	**22.8**	10.9	23.3
12-18 / 7:30 am	Housing Starts – Nov	1.226 Mil	**1.235 Mil**		1.228 Mil
12-19 / 9:00 am	Existing Home Sales – Nov	5.200 Mil	**5.130 Mil**		5.220 Mil
12-20 / 7:30 am	Initial Claims Dec 15	216K	**219K**		206K
7:30 am	Philly Fed Survey – Dec	15.0	**20.4**		12.9
12-21 / 7:30 am	Q3 GDP Final	3.5%	**3.6%**		3.5%
7:30 am	Q3 GDP Chain Price Index	1.7%	**1.7%**		1.7%
7:30 am	Durable Goods – Nov	+1.6%	**+1.0%**		-4.3%
7:30 am	Durable Goods (Ex-Trans) – Nov	+0.3%	**+0.2%**		+0.2%
7:30 am	Personal Income – Nov	+0.3%	**+0.3%**		+0.5%
7:30 am	Personal Spending – Nov	+0.3%	**+0.4%**		+0.6%
9:00 am	U. Mich Consumer Sentiment- Dec	97.5	**97.5**		97.5

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.