Topical Study #72:

After Alan: HELs To Pay?

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I. Next Chairman, Next Crisis

Fed Chairman Alan Greenspan retires at the beginning of 2006. My hunch is that the next Fed Chairman won't be Martin Feldstein, Ben S. Bernanke, or anyone else we know anything about. President George W. Bush is more likely to choose a Texas banker, a good-ol'-boy from his home state. Whoever does get the job may also get a hell of a mess in the home equity loan (HEL) market. Previously, I described HELs as financial weapons of mass destruction.[1] This happens to be one of the few concerns that I share with the perma-bears. The Fed Chairman cleaned up the mess caused by the bursting of the tech and telecom bubble by creating another bubble. This time it is in real estate finance. He refused to raise stock margin requirements to stop the previous bubble. Now he has failed to stop the alarming deterioration of mortgage lending standards to stop the housing bubble.

Of course, the bears have been saying that the housing bubble was about to burst for at least the past two years. I disagreed. I still believe that it won't pop anytime soon, especially since the Fed's recent campaign to talk up bond yields and mortgage rates has failed so badly. The Fed Chairman needs to warn mortgage lenders to tighten their lending standards voluntarily or else the Fed will work with other banking regulators to force them to do so. However, I doubt Greenspan will do so before he retires. So it will be up to the next Fed Chairperson whether the bubble inflates, deflates, or bursts.

In any case, I don't see developments in the housing and mortgage markets causing a problem for the economy and stock market over the next 12 months. Of course, before the housing bubble bursts, tighter monetary policy might cause a financial crisis elsewhere. This is a very good point that has been made by my friend Ed Hyman and his colleague Nancy Lazar at ISI Group. It is true that Fed tightening moves have usually been followed by a financial crisis (Figure 1). However, these events usually marked the end of the Fed's rate hikes. Moreover, they often coincided with major stock market lows creating great buying opportunities (Figure 2).

II. The Fed's True Conundrum

I believe that Fed Chairman Greenspan and his colleagues actually are concerned about a housing bubble. This is why they launched a campaign to raise bond yields and mortgage rates earlier this year. The campaign started when Mr. Greenspan told a Congressional Committee on February 16, 2005 that he was puzzled that bond yields had remained so

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[1] *Topical Study #67*, "Home Equity Loan Bubble?" May 24, 2004. I wrote: "However, if home equity loans continue to grow rapidly, they could reach enough critical mass in a few years to set off a dangerous financial chain reaction. In other words, they are currently like a nuclear power plant. In the future, they could be more like a nuclear bomb."

low. He said that it was a "conundrum."[2] This initial gambit to talk yields up was followed by a press release immediately after the March 22, 2005 meeting of the Federal Open Market Committee that warned, "Though longer-term inflation expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident." Nevertheless, the release stated that the Fed's rate hikes would continue to be "measured," i.e., 25 basis points per meeting.[3]

If the members of the FOMC are really worried about inflation, why didn't they drop "measured" and just go for 50 basis points at the March meeting, or at least prepare the markets for such a hike at the May meeting? Perhaps they are less concerned about inflation as measured by consumer price indicators than about the speculative bubble that is clearly inflating in the housing market fueled by excessive lending. A few weeks ago, I wrote that the conundrum for the folks at the Fed is that if they tighten more aggressively, the bond yield and mortgage rates might actually fall.[4] In this scenario, disgruntled spouses throughout America will berate their mates: "See, I told you we should take all of our money out of the stock market and put it into real estate, or at least into bonds!"

If the Fed is unable to raise the bond yield and if Mr. Greenspan won't stop the mortgage lending orgy, then the housing industry will continue to rock and roll. When will the music stop? Maybe when the next Fed chairperson realizes that if it must end badly, it might be best to burst the bubble by tightening lending standards as soon as possible so that the former Fed chairman can get some of the blame for the mess. In an alternative scenario, the bubble continues to inflate. It eventually bursts not as a result of higher interest rates, but because something else causes a recession and job losses.

Why haven't bond yields soared on the Fed's cues? The 10-year Treasury note yield was at 4.1% the day before Mr. Greenspan's conundrum testimony. It rose to 4.64% on March 28, 2005. Recently, it dropped back below 4.2%. The 30-year fixed mortgage rate is currently around 5.8%, while the one-year adjustable is at 4.2% (Figure 3). Because interest rates remain near their historic lows and because lending standards are so lax, new applications for mortgages to purchase new and existing homes remain near record highs (Figure 4).

I addressed this question in the February 2, 2005 issue of my *Investment Strategy Weekly* titled "Decoding The Yield Curve."[5]

> In my opinion, the shape of the yield curve provides more insight into the fixed-income market's outlook for inflation than for real economic activity. So a flattening yield curve should be welcomed as confirmation that the inflation outlook is likely to remain tame. This is especially so with the flattening over the past year, when the bond yield barely budged.

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[2] All of Mr. Greenspan's speeches and prepared Congressional testimonies since 1996 are posted in the Greenspan Center of my web site, http://www.yardeni.com/Greenspan.aspx.
[3] The full set of FOMC press releases is posted on my web site at http://www.yardeni.com/FOMC.aspx.
[4] See "The Fed's Conundrum," March 28, 2005, http://www.yardeni.com/pub/a_050328.pdf.
[5] See http://www.yardeni.com/pub/a_050202.pdf.

Bond bears claim that yields would have risen significantly by now if only Asian central banks hadn't purchased so many U.S. Treasury securities in their efforts to prop up the dollar. In my opinion, if the "bond vigilantes" really feared inflation, their bond sales would have overwhelmed the purchases of Asian central banks. Besides, the latest data show that the recent bond rally occurred as central banks were buying U.S. Treasuries at a slower pace.[6]

III. Home Sweet Home

Let's take a quick tour of the housing neighborhood to assess the extent of the bubble:

1) ***There is no bubble in housing stocks.*** I have been recommending housing-related stocks since 2002. Since late 2001, the S&P 500 Homebuilding stock price index increased from just north of 200 to just south of 1000 (Figure 5). Given that the stocks have increased five-fold since 2001, I may be overstaying my welcome in the housing market, but I am sticking with the group. The 12-month forward P/E of Homebuilding was only 7.3 in April. This valuation multiple has remained below 10 since February 1999 even though earnings have tripled over the past three years (Figure 6).

2) ***There is no bubble in the stock of new homes.*** New home sales have been very strong in recent months (Figure 7). Homebuilders are building to demand so inventories remain very low relative to sales. In March, the months' supply of new homes for sale was only 3.6 months. Prior to the housing recession of 1990, the months' supply was often above 6.5 months (Figure 8).

3) ***There is a bubble in mortgage finance.*** There is plenty of anecdotal evidence that mortgage originators have lowered lending standards significantly in recent years. Margins are shrinking on all loans including mortgages as the yield curve has flattened. The lenders are clearly hoping that increased volumes will offset narrowing margins. To drum up business, many lenders now offer loans with all sorts of gimmicks:

- No down payments
- Home equity loans equivalent to the down payment
- Below-market teaser rates for a year on variable-rate loans
- Balloon loans that are interest-only for several years before any principal is due
- Heavily discounted closing costs

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[6] See my previous *Topical Study #71*, "FRODOR Guide," April 26, 2005, at http://www.yardeni.com/PremiumData/t_050426.pdf. See also Tao Wu, "The Long-Term Interest Rate Conundrum: Not Unraveled Yet?" *FRBSF Economic Letter*, April 29, 2005 at http://www.frbsf.org/publications/economics/letter/2005/el2005-08.pdf. Mr. Wu agrees with me that foreign central bank purchases of U.S. Treasuries don't explain why bond yields remain so low.

With these incentives, it isn't surprising that the fastest growing credit at financial intermediaries is mortgages, which includes home equity loans (HELs). Home mortgages rose to a record $7.5 trillion at the end of last year, up 13.5% from a year ago. They are up to a record $2.7 trillion at commercial banks, which should be renamed *mortgage* banks since their mortgages well exceed the $976 billion they have in commercial and industrial loans (Figure 9).

4) ***The bubble in HELs is likely to get much bigger before it pops.*** A home equity loan is money borrowed from a line of credit secured by the value of the home. Typically, the borrower pays the prime rate. The rate is usually lower when more is borrowed, according to the terms set by the lender. So going to HELs is seductive. The more you borrow, the lower the interest rate. If you can't make the payment this month, the bank will take what is due from the credit line. If more households tap more of their home equity—effectively turning their home into a credit card—then I can foresee that such a development could seriously exacerbate the next economic downturn.

The actual aggregate line of credit undoubtedly exceeds the amount of HELs outstanding. I wouldn't be surprised if the sum of all the lines is twice or even three times as large as total HELs outstanding, which was $881 billion at the end of last year, up 29% over the past four quarters (Figure 10). This means that HELs account for roughly 12% of mortgages outstanding. Any way you slice it or dice it, banks and other financial intermediaries already have a very large exposure to such borrowing, and the exposure appears to be heading higher fast.

For now, the extra cash is boosting consumer spending and the overall economy. Last year, consumers borrowed $196 billion from their home equity credit lines, or more than twice as much as from traditional consumer credit sources. Of course, some of the home equity borrowing may simply be displacing more costly credit card debt (Figures 11 and 12). This suggests that the credit card business is becoming more competitive and less profitable.

5) ***There is a bubble in home prices.*** In March, the median existing home price rose to $193,600, up 8.7% from a year ago on a 12-month moving-average basis and 25% over the past three years. The one-year rate of appreciation now exceeds all previous cyclical peaks since 1982 (Figures 13 and 14).

The Northeast and the West stand out as the most speculative and the most prone to a painful adjustment. Median price increases in the Northeast actually peaked at 17.8% on a 12-month moving-average basis during June 2004, but still rose 14.1% in March of this year. During the previous bubble in the Northeast, home price gains peaked at 27% (also on a 12-month moving-average basis) during December 1987. By December 1989, they were down 10.5%. In the West the median existing home price was up 14.4% in March,

exceeding the previous cyclical peak of 13.4% during January 1988 (Figure 15). I am not convinced that the housing bubble is about to burst. There are certainly many pockets of speculative excess in the housing market. However, everyone "knows" that there is a bubble that could burst any minute, so it will probably get even bigger before it does so.

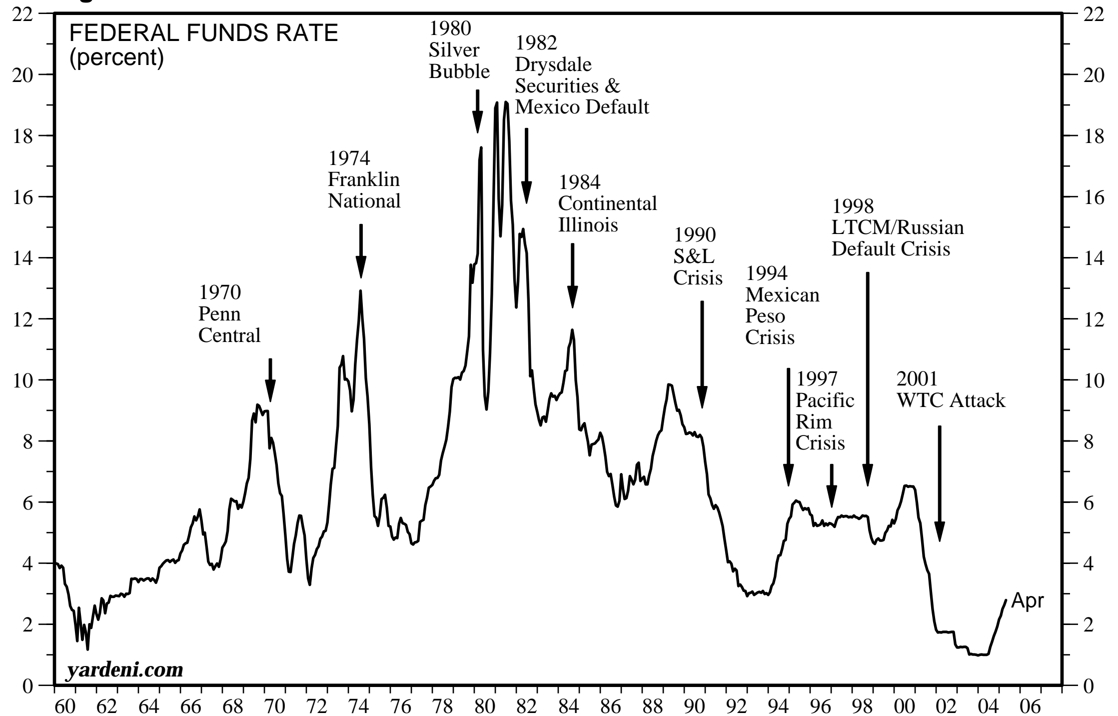
6) ***Housing's P/E is off the charts.*** It is possible to calculate a sort of P/E ratio for household real estate by dividing the Fed's data on the market value of houses by disposable personal income. This ratio soared to a record high of 1.9 at the end of last year (Figure 16). On a trend basis, real estate values have been rising faster than incomes since the mid-1970s when this P/E was 1.1. Should we be worried? Falling interest rates tend to raise the stock market's P/E. The same is true for real estate. Lower mortgage rates mean that for any given income, people can afford to carry more mortgage debt and to pay more for a house. Home mortgages as a ratio of disposable personal income soared to a record 0.85 at the end of last year, more than twice as much as this ratio was 20 years ago (Figure 17).

So as long as mortgage rates remain low and personal income available to service mortgage debt doesn't decline, the housing bubble is more likely to get bigger than to pop.

* * *

- Fed Easing Cycles -

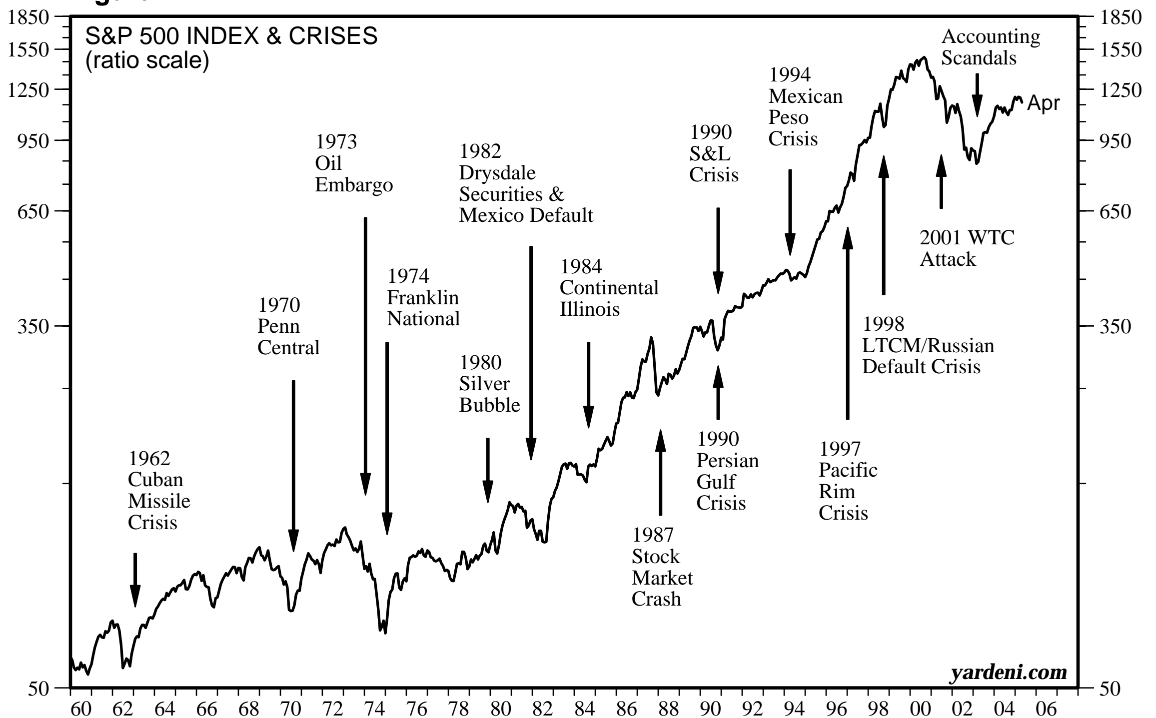
Figure 1.



Source: Board of Governors of the Federal Reserve System.

Fed tends to respond to financial crises by easing, providing a lift for the economy and stock prices.

Figure 2.

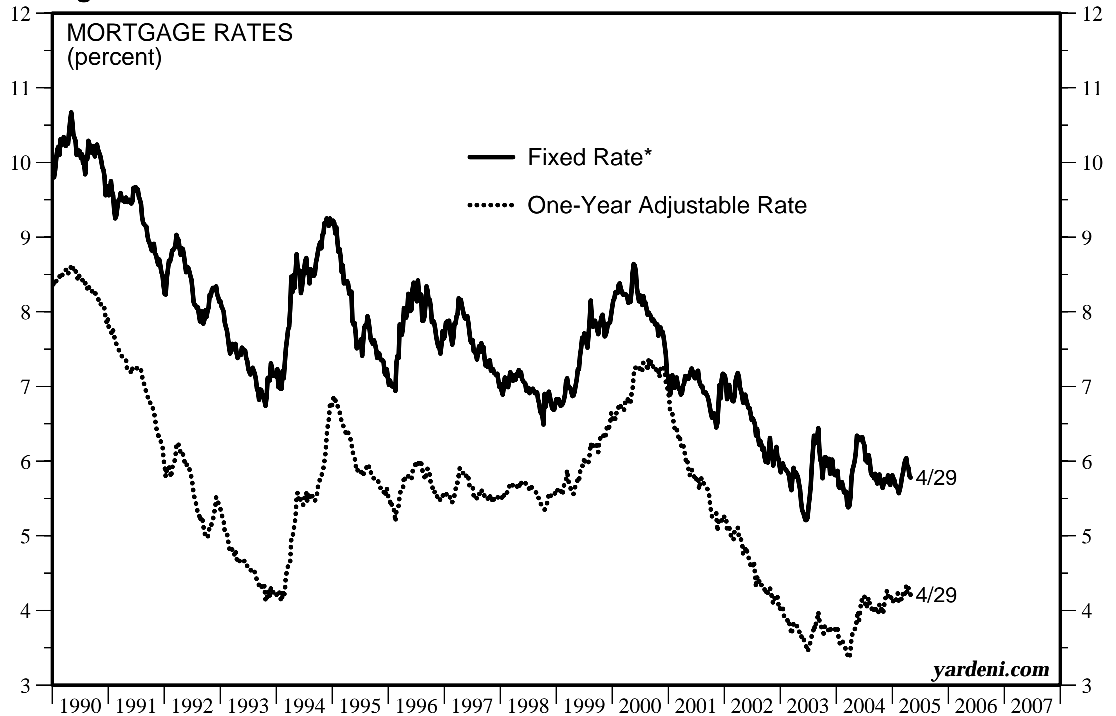


Source: Standard & Poor's Corporation.

- Mortgage Rates & Applications -

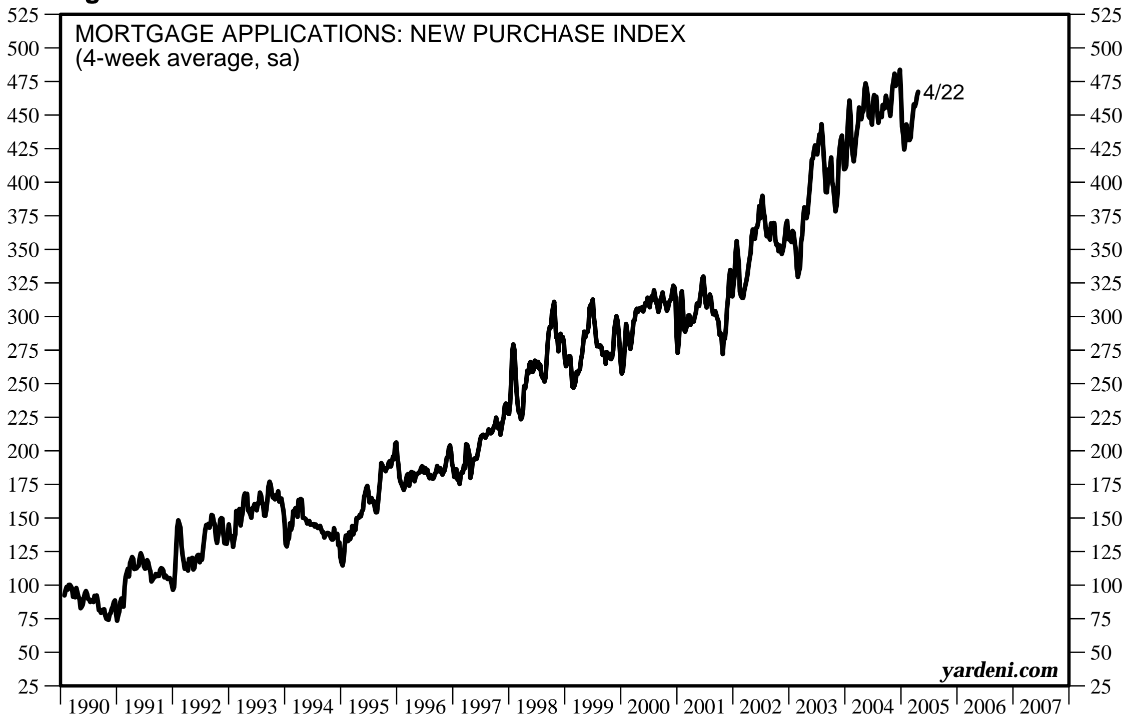
Mortgage rates remain extremely low which is why mortgage applications to purchase new and existing homes are at record highs.

Figure 3.



* Average conventional 30-year commitment rate.
Source: Federal Home Loan Mortgage Corporation.

Figure 4.



Source: The Mortgage Bankers of America.

- S&P 500 Homebuilding -

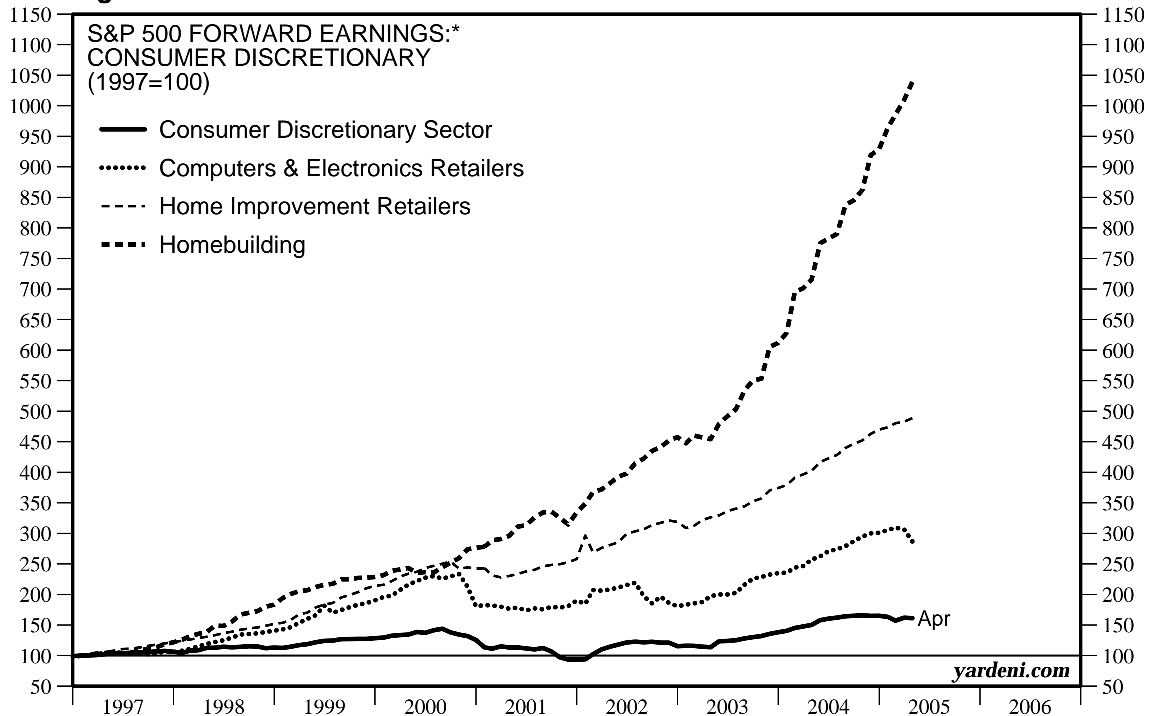
Homebuilding stock prices flatlined during the NASDAQ bubble of the 1990s. Is housing this decades bubble? S&P 500 Homebuilding is up 10-fold since early 2000.

Figure 5.

Source: Standard & Poor's Corporation.

Homebuilding is leading housing-related industries. Homebuilding's forward earnings up 10-fold since 1997.

Figure 6.



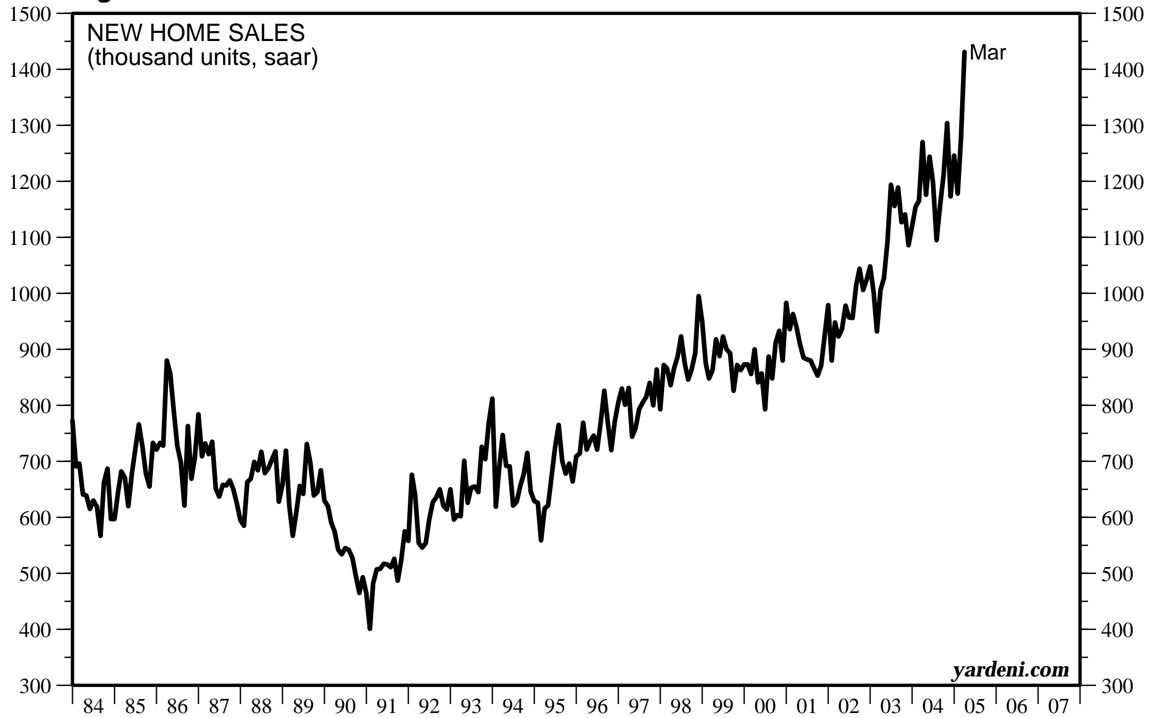
* 12-month forward consensus expected operating earnings per share. Time-weighted average of current and next years' consensus forecasts.

Source: Thomson Financial.

- New Home Sales -

Mortgage rates are low because inflation remains low. So new home sales remain strong.

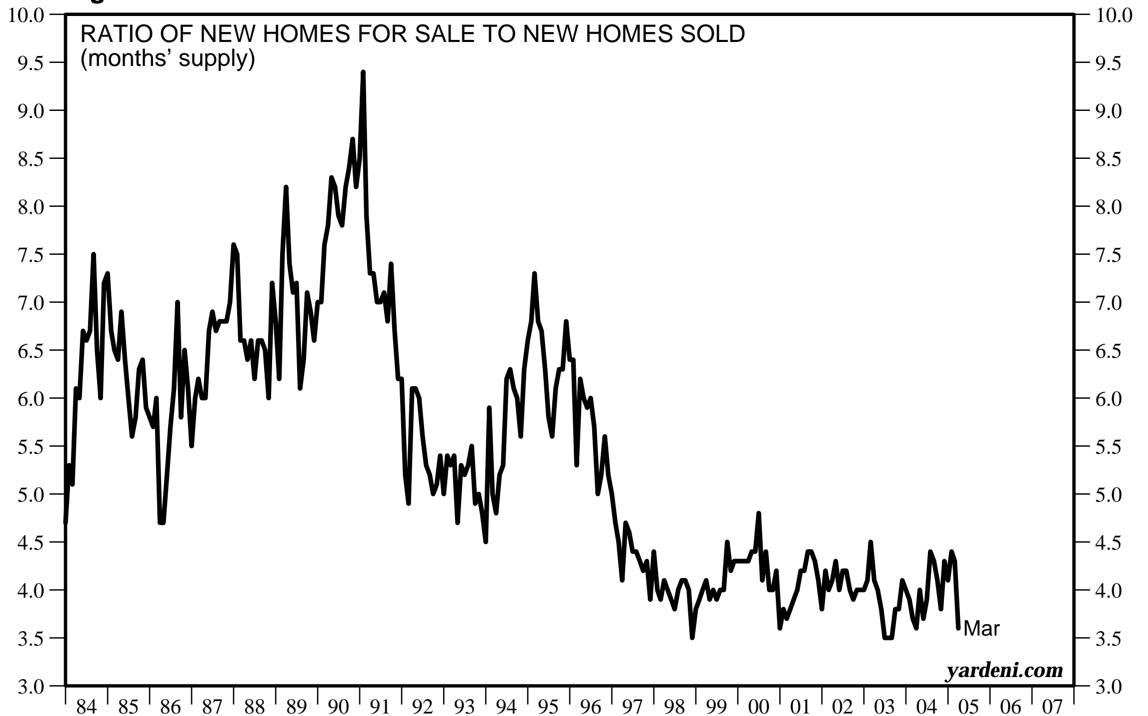
Figure 7.



Source: U.S. Department of Commerce, Bureau of the Census.

No excesses here: Homebuilders are building to demand so new home inventories remain very low relative to sales.

Figure 8.

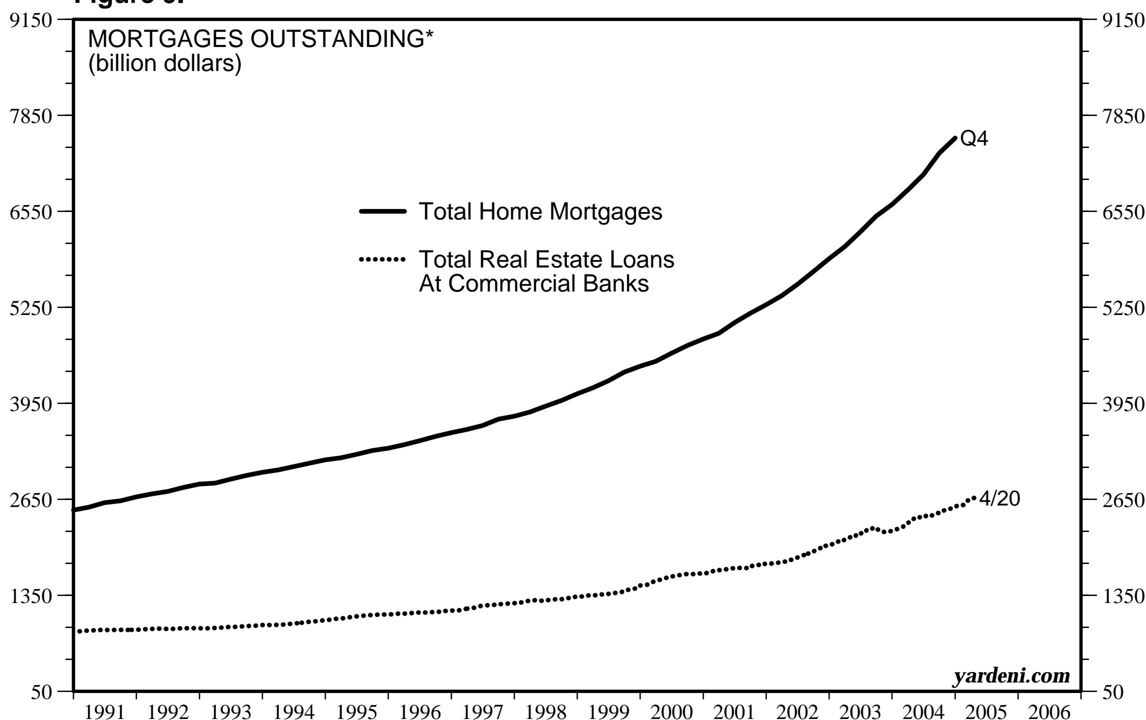


Source: U.S. Department of Commerce, Bureau of the Census.

- Mortgages -

Home mortgages outstanding soared to a record $7.5 trillion at the end of last year.

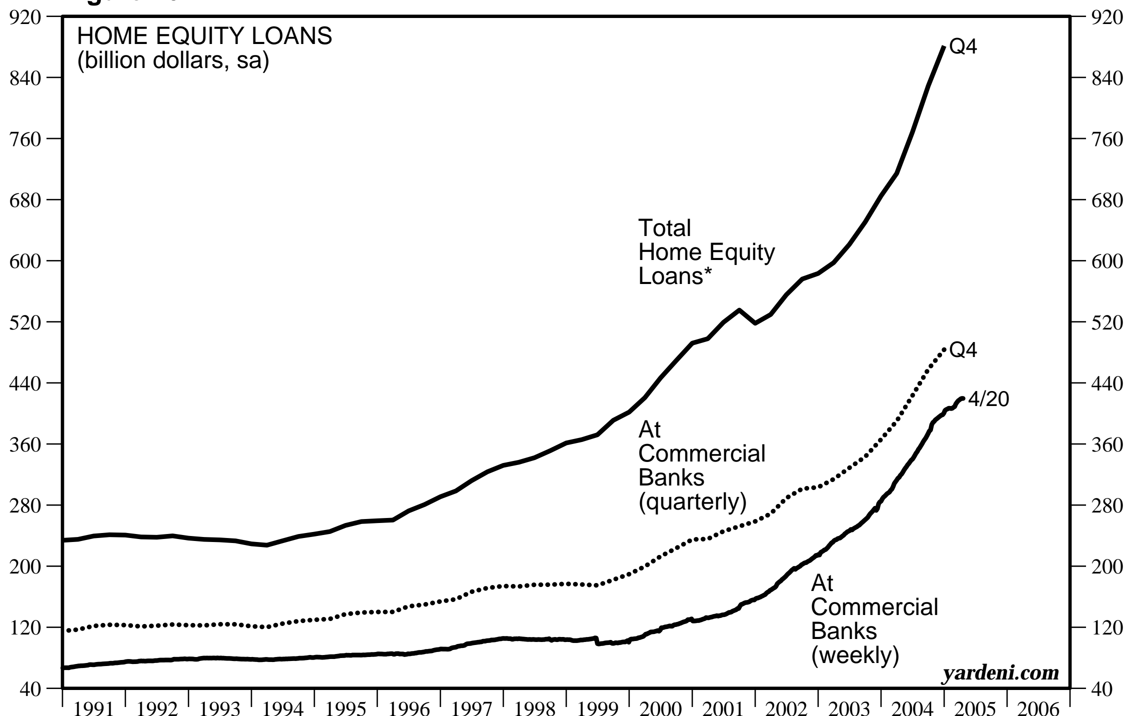
Figure 9.



* Includes home equity loans and second mortgages.
Source: Federal Reserve Board Flow of Funds Accounts.

Home equity loans are included in mortgage data above. They were at a record high of $881 billion at the end of last year.

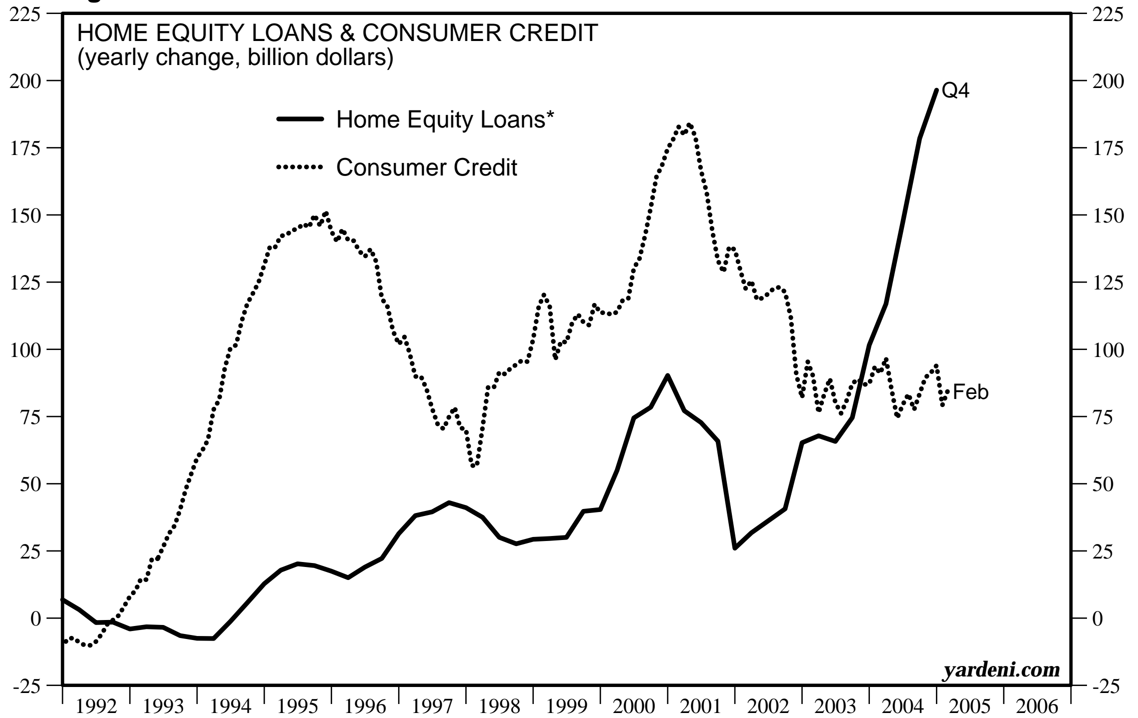
Figure 10.



* Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.
Source: Board of Governors of the Federal Reserve System.

- Home Equity Loans -

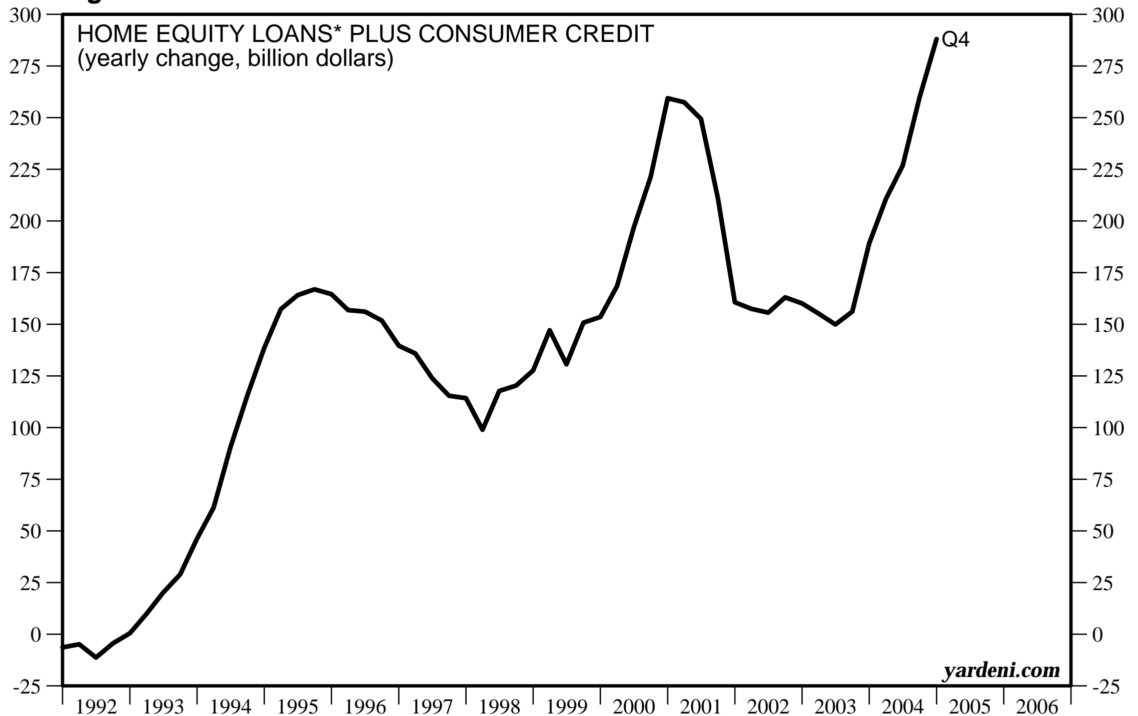
Figure 11.



* Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.
Source: Board of Governors of the Federal Reserve System.

Home equity borrowing is rising at record pace and well exceeds consumer credit borrowing.

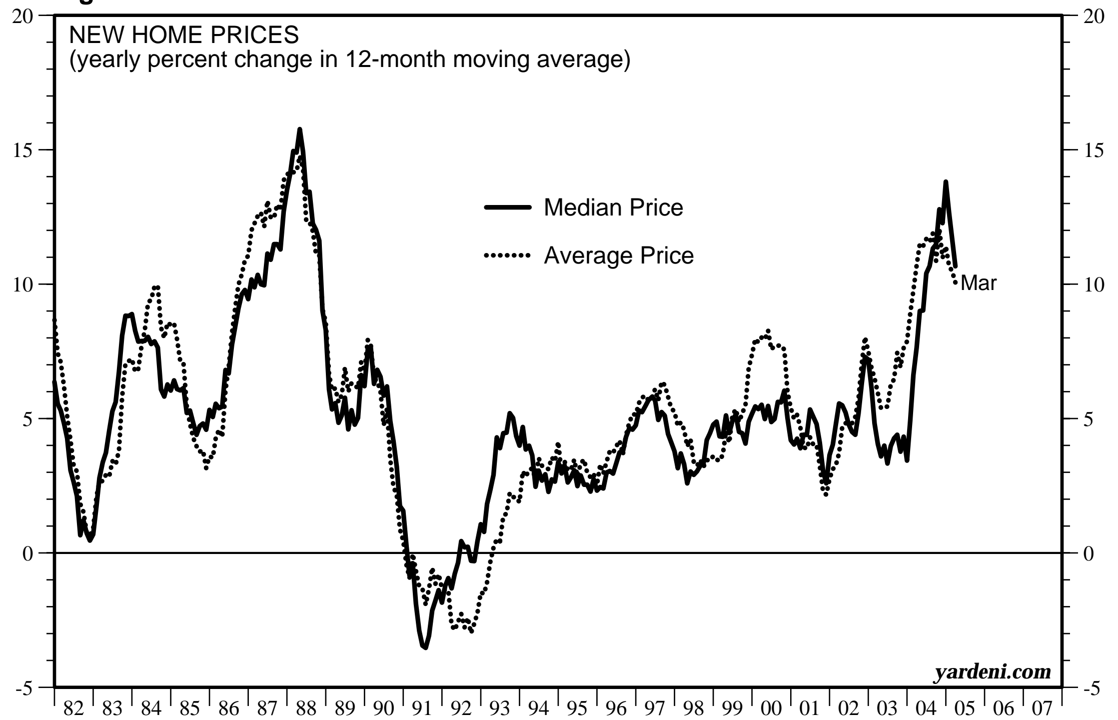
Figure 12.



* Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.
Source: Board of Governors of the Federal Reserve System.

- Home Prices -

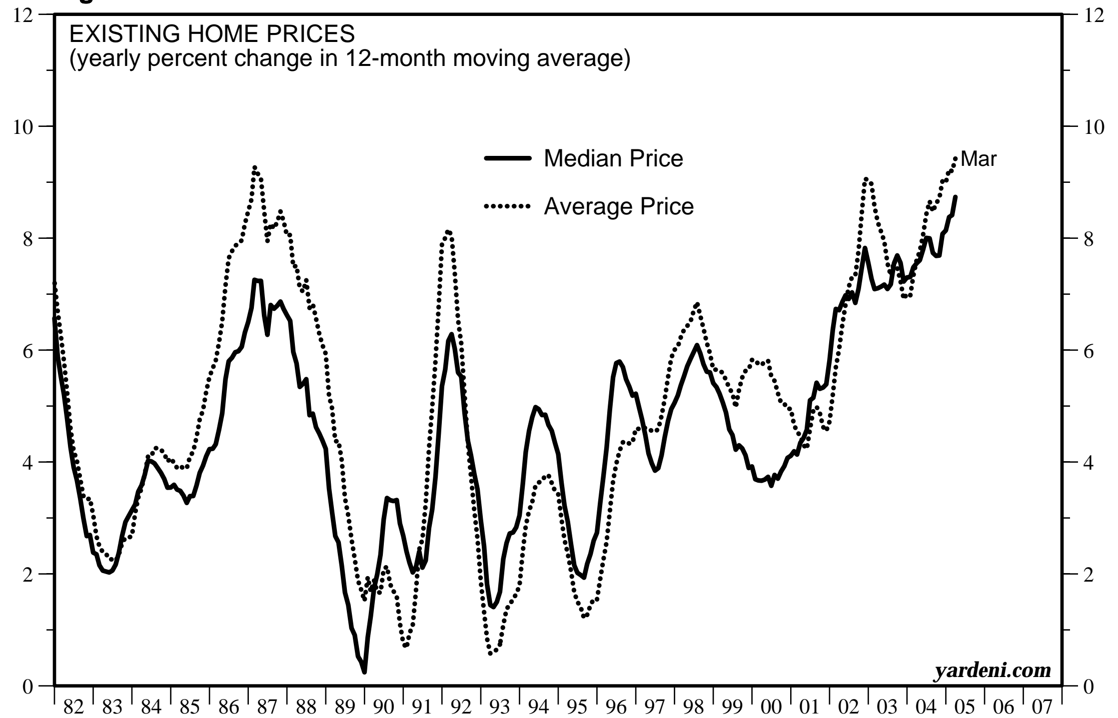
Figure 13.



Source: U.S. Department of Commerce, Bureau of the Census.

Both new and existing home prices are rising rapidly, increasing the potential for a drop in prices when the housing bubble bursts. The most vulnerable regions are the Northeast and West where prices are up 14% from a year ago.

Figure 14.



Source: National Association of Realtors.

- Existing Home Prices -

Figure 15.

EXISTING HOME PRICES
(yearly percent change in 12-month moving average)

Northeast

Median

Average

Mar

Midwest

Mar

South

Mar

West

Mar

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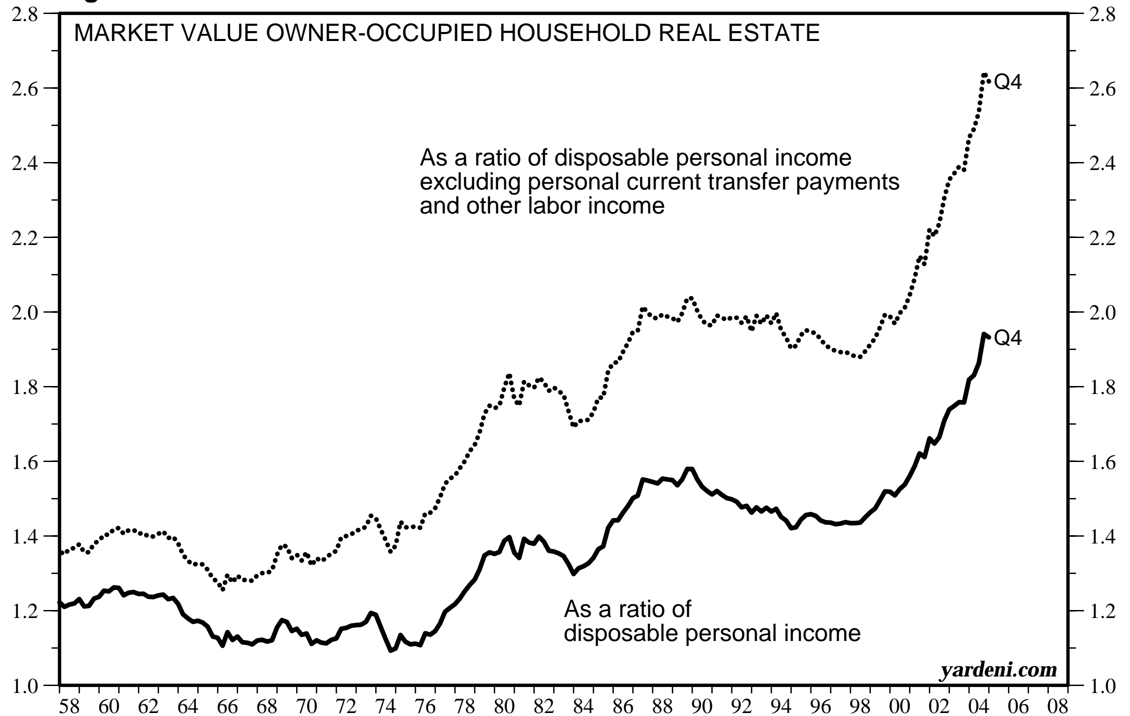
Source: National Association of Realtors.

- Real Estate P/Es -

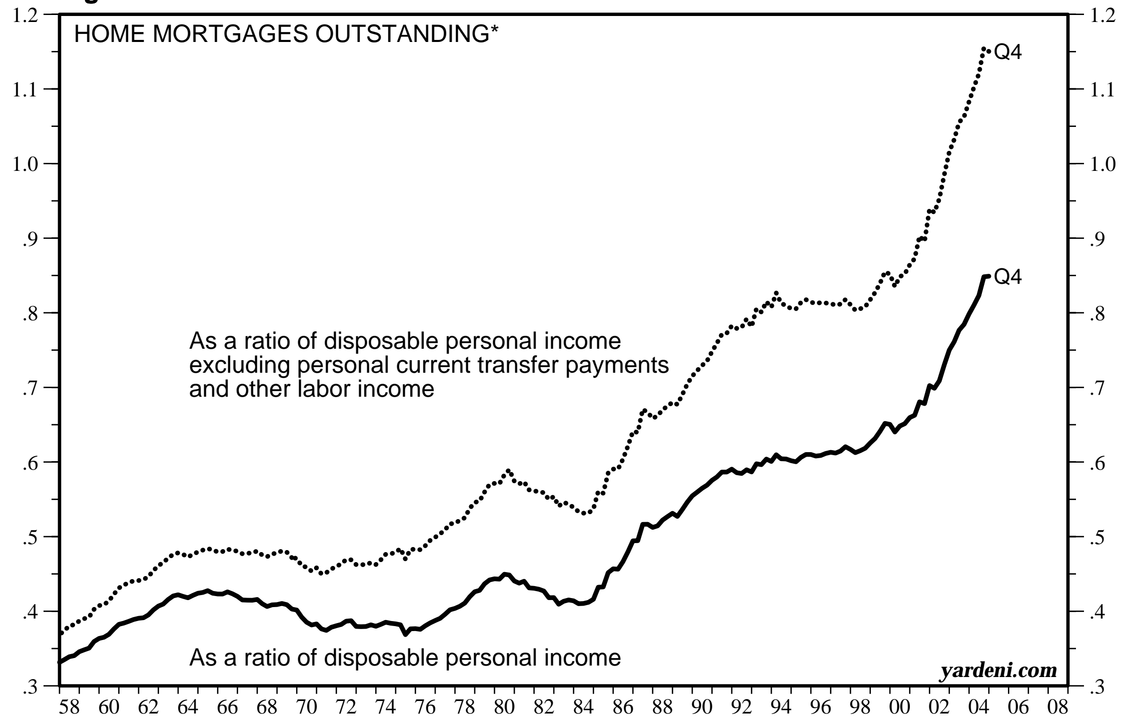
As mortgage rates fell dramatically in recent years, homebuyers could afford to carry larger mortgages and pay more for homes, so mortgages and home values soared to new highs in absolute terms and relative to personal income.

Figure 16.



Source: Federal Reserve Board Flow of Funds Accounts and U.S. Department of Commerce, Bureau of Economic Analysis.

Figure 17.



* Includes home equity loans and second mortgages.
Source: Federal Reserve Board Flow of Funds Accounts and U.S. Department of Commerce, Bureau of Economic Analysis.

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