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Leverage, not home price appreciation, may be the story buried in newspapers today

By Jeff K. Davis

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SNL's Jim Stevens updates the housing market monthly. His Dec. 31 post chronicled the 13.6% year-over-year gain in the S&P/Case-Shiller 20-city composite index through October, building activity, foreclosures and the underperformance of the home builders this year. As very early cyclicals, underperformance of the builders' stocks in 2013 vs. the S&P 500 is not too surprising. The home builders bottomed in 2011 and then had a big run through April 2013 immediately before taper entered the financial market's lexicon.

The mainstream media has been gushing over housing this year. This week's lead article in *Barron's* was titled "Betting on the House." *Barron's* argued that home price appreciation would continue for three more years with gains of about 5% in 2014 and 2015, then slowing to 3% in 2016. *The Wall Street Journal* in a Dec. 29 article discussed the same theme, noting that prices are back to all-time highs in 10 of the 50 largest MSAs and within 5% of their previous peak in San Jose, Nashville and Dallas, according to Zillow. Given the booming IPO market — a good thing in my view for the U.S. economy — no one should be surprised that Palo Alto prices are 40% above their prior peak.

My modest corner of the world, Nashville, provides a window on the broad swath of housing in the middle of the U.S. that is outside the international capital flows that are plowing into real estate in New York, Miami and San Francisco. The median price for a residential home rose 8% to $195,500 in November from $179,900 a year ago; the median condo price eased 1% to $150,000, which is interesting because Nashville is on the verge of another condo tower building spree as occurred a decade ago. My realtor friends tell me both housing and condo inventories are tight and that is impacting sales and their W-2s. Residential closings rose 4.1% in November from a year ago, but year-to-date closings are 18.9% higher than the first 11 months of 2012.

Tight inventory should push prices higher and accelerate construction. Nashville is a growing city with steady in-migration; its real estate market is the largest in the state with sales that are almost twice that of Memphis and Knoxville combined. Maybe the slowing pace of gains reflects a combination of pent-up demand having been satiated and higher prices and higher mortgage rates taking the edge off the market. Housing activity could be at an inflection point; or maybe it is a pause that refreshes.

Like most assets financed with a generous amount of leverage, housing performed very well in 2012 and 2013. For whatever reason, most of us tend to focus on the value of the asset rather than the return on equity — maybe because housing should not be viewed as an investment. *Barron's* prediction about mid-single digit gains the next few years sounds modest; however, it equates to a ~20% return before financing costs if the home owner has 25% equity. And *Barron's* is predicting a few years of price gains.

If that seems to be too good to be true, perhaps it is because the Federal Reserve is subsidizing leverage and asset values through its suppression of interest rates. Maybe implementation of tapering means 2014 could be a surprise year like 1994 when rates rose much more sharply than the consensus expected. If so, year-over-year price gains in housing could disappear as sellers pull inventory waiting for price momentum to resume and buyers wait for rates to ease.

A comparable analogy is a bank bond portfolio. Unrealized gains a year ago were huge, but those gains have evaporated this year as the 10-year moved toward 3% by year-end from 1.8% at the beginning of the year. And as tempting as a very wide yield curve is, bank treasurers seem reluctant to add bonds even though the spread on the carry is wide. Funding additional bonds with short-term borrowings or excess deposits can produce incremental income to pad budgets and bridge a gap to analysts' EPS estimates. However, should rates move higher, say toward 4%, no CFO or treasurer wants to walk into the CEO's office or the boardroom and announce that the unrealized loss in the bond portfolio is comparable to losses that were realized in the CRE portfolio in 2009. Termination could become a reality, and severance packages are not as generous as they were before the crash.

I am on record as having the view that long-term rates will not go up much because asset values — like housing — are so dependent upon the subsidy from the Federal Reserve. Absent asset inflation, the economy may not look so robust. I assume that because the demand for credit is weak and because the Fed has publicly committed to keep short rates anchored near zero for a long time. But I could be wrong. The unwinding of leverage can be swift, brutal and occur when it is least expected.

So when a story like home appreciation makes it to the front page, is it destined to stay there? Art Cashin, UBS Financial Services' widely followed director of floor operations, regularly comments that investors should pay attention to stories buried in the newspapers that may bubble to the front page in time. I think leverage is one of those stories, but it may remain buried for the time being if the credit markets remain well behaved in 2014.

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