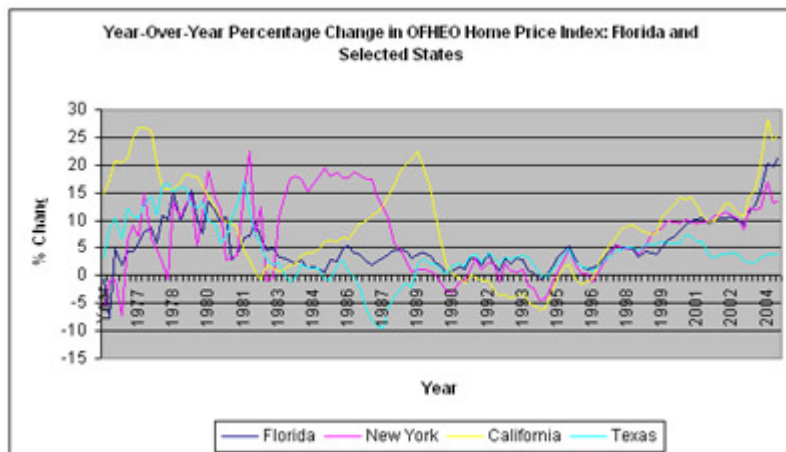
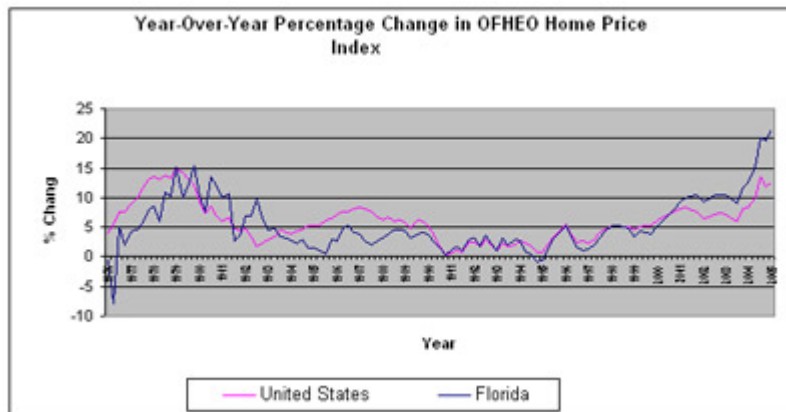




Is There a Bubble in Your House?



Florida has a long and fascinating history of real estate cycles, dating at least as far back as the 'roaring '20s' boom in Coral Gables where residential real estate prices rose by an estimated 220 percent between 1924 and 1925 only to soften in 1926 and then collapse following the "storm of 1926" (hurricanes were not named at the time). Today, many analysts are wondering if Florida is experiencing another cycle given the hefty escalation in residential real estate prices that began in about 2000.

The graphs and table to the left show the extent of the recent rapid rise in housing prices. They present information on the annual percentage change in the prices of single-family detached properties for Florida, the U.S., and selected states as well as the six largest Metropolitan Statistical Areas (MSAs) in Florida. Several interesting points to note:

1. Nationally, housing prices are rising at double-digit rates for the second consecutive year, and have advanced by a cumulative 40 percent from 2000 - 2004 compared to a cumulative inflation rate of 10.85 percent.
2. The increases in housing prices in the four most populous states (California, Texas, New York, Florida) since 2000 have consistently and significantly outpaced the national average growth rate, with the exception of Texas.
3. Florida is the only state where the rate of increase has accelerated each and every year since 2000. All the other states and the nation exhibited slower growth in the 2002 - 2003 timeframe. Florida trails only California in terms of the cumulative ascent in housing prices among the four most populous states.
4. Housing price increases have been especially pronounced in the South Florida MSAs encompassing Broward, Palm Beach and Miami-Dade counties. Prices have soared by cumulative totals of 68, 67, and 66 percents, respectively, from 2000 - 2004 in these three counties and the data for early 2005 show no signs of abatement.
5. Since the inception of the price indexes there has been no comparable five-plus year period for the nation, Florida, and Florida's six largest MSAs when prices have accelerated as rapidly as the 2000 - 2005 periods.

Do these data indicate a bubble in Florida real estate in general, and in South Florida in particular? Will we witness a collapse in housing prices such as occurred in 1926; or something similar to the dot com crash; or along the lines of the plunge in property values in Tokyo? Or, will prices continue their strong ascent, or level off? Are we observing a one-time jump upward before a return to more normal price changes? What might happen to Florida's robust economy if residential real estate prices contract?

Percentage Change in Home Prices in Florida Metropolitan Statistical Areas

Year	Ft. Lauderdale	Jacksonsonville	Miami- Dade	Orlando	Tampa	West Palm Beach
2000	7.99	7.24	6.50	6.50	8.25	7.75
2001	12.77	8.75	11.50	8.50	10.50	10.25
2002	13.87	8.50	14.10	7.75	9.41	13.00
2003	13.16	8.60	13.89	7.50	8.75	14.00
2004	19.72	12.50	19.68	13.13	15.23	21.88
2005**	32.62	14.57	21.00	18.66	19.04	25.82
Cumulative Increase						
2000-2004	67.51	45.59	65.67	43.38	52.14	66.88

Source: Office of Federal Housing Enterprise Oversight. The OFHEO residential real estate price indices are for single family detached properties; are geometrically weighted price indexes based on repeat sales or re-financings of the same property, which helps to adjust for quality differences among residences, and apply only to conventional, conforming mortgages. The OFHEO price indices can be viewed as capturing price changes for all but the most expensive single family detached residences. Condominiums and townhouses, important elements of the Florida residential real estate market, are excluded from the indices. The base years for the state and MSA price indexes are the first quarters of 1980 and 1995, respectively.

**Percentage increase from first quarter 2004 to first quarter 2005.

The candid answer is I do not know with a high degree of certainty, but increasingly suspect that a bubble is present and is centered in South Florida. Bubbles are conventionally defined as periods when buyers continue to buy the asset in question (housing, stocks, commodities, etc.) even though they are aware that its price exceeds its fundamental economic value. Investors continue to buy based on the expectation that they will be able to sell at a sufficiently higher price so as to provide an acceptable risk-adjusted return.

Although bubbles can be easily defined, statistically proving their existence before the fact is extremely difficult. A quote from a recent research paper entitled "Econometric Tests of Asset Pricing Bubbles: Taking Stock", by Federal Reserve Board economist R.S. Gurkaynak nicely summarizes the dilemma: "Tests of bubbles are inconclusive. Statistical testing of asset price bubbles cannot be achieved with a satisfactory degree of certainty. We cannot (empirically) distinguish bubbles from structural changes in economic fundamentals."

If our empirical models are inconclusive, then we must rely on our best judgment of the facts to discern whether or not a residential real estate bubble is present. In this regard economic fundamentals must be carefully analyzed to determine if structural changes have occurred. Is it really "different this time" as many who do not see a bubble claim? Here is one economist's assessment of the fundamentals:

- Strong and Healthy Economic Growth:** Spurred by a highly favorable economic environment, Florida's economy has been one of - if not the strongest state economy in the nation over the last five years by any measure. Per capita income has increased a healthy 13.22 percent, sparking the demand for many goods and services including housing. Moreover, the outlook calls for continued growth. Florida's economy is likely undergoing beneficial structural changes. However, even in an economy as vigorous as Florida's it is difficult to see this translating into the torrid housing price increases we have observed unless some other thing or things have radically changed.
- Population Growth and Demographics:** Florida's population has been growing recently at a rate of about 2.30 percent per year or in the 350,000 - 400,000 range. This is robust growth for an already large state and undoubtedly has contributed to the uptrend in housing prices. But, our population growth rate is not appreciably different from the 1980s and 1990s when housing prices were rising by an average of about 4.00 percent per year. Population growth alone cannot explain the rapid run-up in housing prices.
- Non-Local Buyers:** Whether from out-of-state, out-of-country, or out-of-hemisphere, for many years non-local buyers have been a part of the demand for Florida residential real estate. There is no evidence of a sustained boost in demand from non-local buyers over the last five years compared to the past. Non-local buyers alone cannot account for the escalation in housing prices.

- **Low Interest Rates:** Especially when adjusted for inflation and taxes, the low interest rate environment beginning in 2002 has likely been a major force behind the rapid appreciation in residential real estate prices. However, it is hard to imagine that housing demand in Florida is so much more sensitive to low interest rates than in the rest of the nation to account for Florida's soaring prices.
- **Supply Constraints:** Homebuilders in Florida, as is the case in many states, face state and local laws and regulations that may act to constrain the supply of new housing units and raise their cost. However, Florida has been among the national leaders in the number of new housing units constructed since 2001. Limits on supply do not appear to be the primary force behind higher housing prices. The ascent in housing prices appears to be driven largely by growth in demand.
- **Florida Real Estate Is Relatively Inexpensive:** The obvious question here is, "in comparison to what?" Florida real estate has been, arguably, undervalued compared to areas like Manhattan, Boston, San Diego, London, Paris, Hong Kong and Tokyo but not necessarily in comparison to areas such as Atlanta, Denver, Dallas, Baltimore, Frankfurt, Milan, and Sydney.
- **New Mortgage Products:** Waves of new and innovative mortgage products have emerged in recent years, as part of the ongoing innovation in the financial sector. By and large these new products and innovations have created substantial value for consumers. Less conventional financing vehicles have surely enabled many buyers to purchase and invest in homes than otherwise would have been possible. At the same time not all consumers and providers of new mortgage products may yet fully understand their risks and other features. Federal Reserve Board Chair Alan Greenspan, in his semiannual Monetary Policy Report to Congress delivered on July 20, 2005 was moved to comment on the effects of new mortgage products when he said, " interest only loans and the introduction of more exotic forms of adjustable rate mortgages are *developments of particular concern.*" (italics added)
- **Speculators and Investors:** Low interest rates and new mortgage products, especially those allowing 'interest only' type loans for the first few years, have been an elixir for those seeking to speculate and invest in real estate as they permit greater leverage and reduce the initial income and cash flow requirements. Additionally, the fact that the surge in real estate values has occurred at the same time as when segments of the stock market have been moribund does not appear to be a coincidence. Speculators and investors may have moved from dot coms to doorknobs. Behavioral finance theorists talk about 'overconfident' investors who assign any gain to their talents and ascribe any loss to just bad luck, and their resultant penchant for concentrating their investments. This could be happening now.

What, then, can be concluded? My assessment is that changing economic fundamentals such as Florida's healthy and more diverse economy, strong population growth, non-local buyers, low interest rates, and relatively low prices have combined to produce a one-time increase in prices that has taken several years to play out and is probably not yet at an end.

While these factors account for a reasonable portion they simply cannot account for all of the rapid run-up in Florida residential real estate prices, particularly those in South Florida. Since about 2004, prices have appeared to increasingly diverge from those driven by economic fundamentals alone, even accounting for structural changes. A highly credible empirical model developed by my former student Luis Guerra indicated that as of early 2004 prices in Miami-Dade County were about 15 percent overvalued. Prices have risen another 30 percent since then.

The course of interest rates and the timing of re-financings of speculator/investor mortgages are, in my estimation, the two key elements to how long the rapid uptrend in the cycle can last. Bubbles burst when investors sell en masse to take advantage of the overvaluation. Real estate, however, is generally a less liquid asset than stocks and bonds and subject to higher transactions cost. Slow erosion, adjusted for inflation, in residential real estate values might be more likely than a sudden crash, but a lengthy, gradual falloff in prices could constrain the state's economy for a longer time. Florida's improved economic diversity should help to cushion any slackening in the residential real estate sector.

Generations of economics professors have put generations of college students to sleep by droning on about the law of diminishing returns. In its simplest form the law just says that, with few exceptions, trees, stock prices, and housing prices don't grow to the sky. Federal Reserve Chair Alan Greenspan also stated in his semiannual Monetary Policy Report to Congress " there do appear to be, at a minimum, signs of froth in some local housing markets where home prices seem to have risen to unsustainable levels. Among other indicators, the significant rise in purchases of homes for investment since 2001 seems to have charged some regional markets with speculative fervor." When the nation's best-known economist says it, it might be time to wake up.

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