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Are the bubbles back?

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The stock market has come roaring back in the last three years, rising to levels close to 10 percent above pre-recession peaks. The housing market has also turned around, with nationwide house prices achieving double-digit increases year over year. Many markets have seen increases of more than 20 percent year over year.

This picture has led many people to ask whether we are seeing the return of the bubbles that drove the economy over the last two decades. I would encourage calm. Stock prices are somewhat high by historic standards, but hardly in bubble territory. Adjusted for inflation, nationwide house prices are above their mid-1990s levels, but still down by more than one-third from their bubble peaks. But there are some seriously disturbing signs in many local markets that warrant close attention.

The run-up in the stock market

The reversal in the stock market over the last three years has truly been extraordinary. The S&P 500 bottomed out at just over 680 in March of 2009. In June of 2013 it stood at more than 1615, an increase of more than 130 percent in little more than three years. While this sort of run-up is extraordinary, it is important to remember that it is starting from a very depressed base. Before the downturn, the S&P had peaked at 1560 in the fall of 2007. If we assume the economy has a potential growth rate of 4.5 percent (2.0 percent inflation and 2.5 percent real growth), then the S&P would have to be at almost 2000 in June of 2013, a 20 percent increase from the June level, to be as high relative to the size of potential GDP as it was in the fall of 2007. Unless we think that the market was in a very serious bubble in 2007, it could not plausibly be in a bubble at present.

Looking to 2000, when the market was certainly in a bubble, the S&P is at roughly the same level as it was more than 13 years ago. If we impute 13 years of 4.5 percent nominal growth to the S&P at its March 2000 peak, it would be at almost 2900 today, roughly 80 percent above its current level. There is clearly much room between current stock prices and the bubble levels of the late 1990s.

We can look at the market in slightly different way by taking the ratio of stock prices to corporate earnings. It is easiest and probably most useful to do this for the economy as whole, since that gives us the best data. The Federal Reserve Board reported the market value of the equity of domestic corporations as $21.5 trillion at the end of the first quarter of 2013.[1] The Commerce Department reported after-tax profits of U.S. corporations for calendar year 2012 as $1.5 trillion.[2] This translates into a price to earnings ratio of 14.3, right about the long-term average.

[1] Board of Governors of the Federal Reserve System, Financial Accounts of the United States Table L.213, Line 23, available at http://www.federalreserve.gov/releases/z1/Current/.
[2] Commerce Department, National Income and Product Accounts, Table 1.12, Line 15, available at http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=1&isuri=1.

Of course profits have been unusually high in this recovery as the weakness of the labor market has prevented workers from getting any share of the productivity growth that has taken place over the last five years. Presumably at some point the economy will strengthen somewhat and workers' bargaining power will increase. Of course this would imply more than trend growth so that the loss in profit share will be at least partly offset by a larger GDP.

The Congressional Budget Office estimates that the economy is 6 percent below potential GDP. This means that even if there were a sharp drop in the profit share of income, say 25 percent, associated with a return to potential GDP, profits would only fall by a bit more than 20 percent from their current levels. In the context of the price to earnings ratio, if the economy returned to trend GDP tomorrow and the profit share plunged by 25 percent, and market values did not budget, we would be looking at an economy-wide price to earnings ratio of 18.

That might be somewhat higher than the historic average, but would hardly qualify as bubble territory. No one has a good enough crystal ball to say what the proper price to earnings ratio for the stock market should be, but it seems a bit of stretch to say that a PE ratio that is 20-25 percent higher than the long period average is a bubble.

Housing: is the mania returning?

News reports were close to ecstatic over the double digit increases reported in various house price indices in May and June. While a bounce back from what were clearly depressed levels in many markets is good news, the overall picture is not necessarily one warranting celebration.

Taking the national data first, there is probably not too much to worry about in the most recent numbers. Using the Case-Shiller national inflation-adjusted house prices were about 17 percent higher in the first quarter of 2013 than they were in the first quarter of 1996, before the bubble had begun to boost prices. They are almost exactly the same as they were in the first quarter of 2000. By comparison, they are still down by more than 35 percent from the peaks reached in the summer of 2006. As with the stock market, crystal balls are not so accurate as to tell us exactly what house prices should be. But even if the 1996 values are closer to what fundamentals might dictate, it would be difficult to view an increase of 17 percent as a bubble, especially with mortgage interest rates at their lowest levels in more than 50 years.

While it may be possible to be sanguine about the national data, there are many local markets where there could be cause for concern. House prices in many local markets have been increasing in recent months at more than a 40 percent annual rate. These rapid rates of price increase are occurring in what had been the most beat-up markets during the crash. This list includes the bottom third of the market in both Las Vegas and Phoenix, as well as many of the cities in the central valley in California that were ground zero for the housing bubble.

According to accounts from realtors and in the business press, as well as data on the percentage of homes bought with mortgages, the run-up in house prices in these areas is being driven largely by investors. In some areas the majority of the homes are being purchased with cash rather than mortgages, which is usually a good sign that the purchaser is not an owner/occupant. There are also accounts of the same sorts of frenzies that were seen in the bubble, with houses in some market routinely drawing multiple bids and buyers coming in with escalator clauses in their offers.

This sort of behavior should provide serious ground for concern about the course of prices in these markets. For the most part, these markets to date have just been recovering lost ground. For example house prices in the bottom third of the Phoenix market are just back to their 2003 level in nominal terms, implying that they are still more than 20 percent lower adjusted for inflation. In Las Vegas nominal prices for homes in the bottom third of the market are just back to their 2000 level. There would be a similar story for most of the central valley cities.

However, even if current price levels are not in any obvious way out of line with the fundamentals in the market, if prices rise very long at a 40-plus percent annual rate, they soon will be. For this reason it will be important to keep a focus on these markets.

It is worth noting that the risk is not to the health of the national economy, as was the case in the bubble years. Housing construction is recovering but is still well below normal levels. If prices were to again collapse in these markets it would not have enough of an impact on construction to be felt in the national data. Similarly, the impact of any wealth effect from this run-up would be too limited to affect national consumption data. And there is no reason to believe there is the same sort of house of cards financing that we saw with the explosion of subprime and Alt-A lending during the last decade.

If these bubbles burst the immediate losers will be the people speculating in these markets. This will include many hedge funds and private equity funds that have been buying up blocks of homes with the hope of renting them out for a period of time and then reselling them, or in some cases just fixing them up and reselling them. There are also many small-time speculators doing the same thing, just as was the case in the housing bubble years. When the music stops, these folks will all take a big hit. That will be bad news for them, but they should know the risks of this sort of investment.

The unfortunate part of this story would be ordinary homeowners who again buy into a bubble market, wrongly believing that housing is a safe investment and a sure way to build some sort of nest egg for the future. Just as tens of millions of people found themselves in homes that were worth less than what they paid in the last bubble, we may see hundreds of thousands of homeowners again ending up in this situation if we get a new bubble.

This would be a tragedy. We can’t expect the average homeowner to approach the real estate market with the same savvy as a Wall Street investor. While we can’t keep people from choosing to buy homes, hopefully they will not get the same push to buy into a bubble market as they got in the last decade, not just from the industry, but also from the government and non-profits promoting “asset-building”. You don’t build assets by paying 20 percent too much for a house.

Anyway, this is the biggest immediate risk that the economy faces from a housing bubble. It is not a nationwide story, but rather a number of limited markets with extraordinary rates of price increase. This does not rule out the possibility that the national market will maintain a double-digit increase for a long enough period of time that it too will be in bubble territory, but that does not seem to be an immediate concern.

There is one last point worth noting. The extraordinarily low interest rates of recent years undoubtedly provide some boost to house prices. Historically house prices in the United States have not been very sensitive to interest rates, but that may be changing somewhat going forward. Of course the implication of more interest sensitive house prices is that if interest rates rise in the next few years, as is almost universally expected, then house prices will fall.

That is likely to be less of an issue in the United States than in countries like Canada, Australia, and the United Kingdom, all of which have average house prices more than 50 percent higher than in the United States. It is likely that the extraordinary price levels in these countries are in large part the result of low interest rates. This fact is likely to pose a serious problem for these economies as the world economy recovers. Higher interest rates could send house prices in all three countries plummeting, which will certainly dampen their recoveries, if not actually throw them back into recession.

It may turn out to be the case that we are now in an era, at least in some countries, in which house prices will move more like bond prices in response to interest rates. In principle there is nothing wrong with this, but it is unlikely that many homeowners in these countries now recognize that they can expect to sell their home at a much lower price if interest rates rise. This education process could prove quite painful for tens of millions of homeowners.

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