Is Housing Undervalued?

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The housing market isn't nearly as mysterious as it seems. Much public confusion stems from our failure to clearly define our terms. Take the popular, long-standing belief that housing is overpriced and unaffordable relative to income. It was said 30 years ago and it is still being said today. The key to solving this puzzle is to widen the definition of income so that it includes the increase in existing wealth. Milton Friedman, in the course of the work on consumer spending that won him a Nobel Prize, introduced a much broader, long-term measure of income called "permanent income" -- including capital gains, physical assets and factors like education that would affect a consumer's earning potential.

Permanent income grows at the same rate as wealth, and generally faster than conventional forms of income. Friedman demonstrated that households base their spending decisions on permanent income rather than on narrowly defined income, such as short-term wages. Fifty years later this idea has yet to sink into our national consciousness. Yet, in a highly developed and wealthy country such as the U.S., annual gains in the value of pre-existing assets are getting larger and larger relative to annual cash income from wages, rents and dividends.

Home prices behave the way they do because housing is not a typical consumer good. Rather, it is a capital asset for which the price is set by the markets for capital assets. These markets continually clear in a way that typical consumption markets do not, and housing is therefore being constantly re-priced. In this limited sense, real-estate prices behave like the prices of other tangible assets such as commodities. Of course, in other ways housing is quite unlike a commodity -- it is immobile, provides services such as shelter to its owners, and its price is geographically very specific. Still, the general level of housing prices, when measured as an index, is as acutely and promptly sensitive to an uptick in inflationary pressures as are other forms of financial or tangible capital.

Inflation tends to boost housing prices in the same way that it boosts the price of any tangible asset. And inflation is surely a major part of the housing-price story. Over the past three decades, the price of housing at the national level has risen at a rate similar to the growth of nominal GDP, and the correlation between housing prices and GDP is statistically significant. But the relationship between housing prices and the prices of highly inflation-sensitive assets such as commodities is much more impressive than the relationship with the economy. There is a particularly strong correlation between percentage changes in housing prices and percentage changes in the price of gold -- especially when a short time lag is taken into account.

When paper money is depreciating rapidly, as in the last five years, it is normal for tangible assets such as housing to appreciate more rapidly than usual, while financial assets such as stocks and bonds tend to perform relatively poorly. This can be understood in terms of the flow of financial capital from one economic haven to another. Capital is mobile. It flows out of assets that are vulnerable to the dollar's depreciation, and into assets that are invulnerable. Capital promotes growth and price appreciation in the sectors into which it migrates, at the expense of the sectors from which it escapes.

Instead of viewing the price performance of housing during the first half of the current decade as a "bubble," I see it as having appreciated for the same reason that the prices of commodities and other tangible assets have appreciated. In nominal dollar terms these prices have to rise in order to maintain the status quo in real terms. The rise in housing prices is one more symptom or early warning of the inflation of which the Fed (rightly) is so fearful.

To better understand housing-market trends, we need to clearly distinguish between real and nominal terms. I define the "real price of housing" as the ratio of the national home-price index to an index of precious-metals prices, while the nominal value refers to the price in dollars. Failure to draw this distinction can cause great confusion. For example, the annual gain in the nominal price of housing averaged 4.8% in all the years in which the Fed lowered interest rates, and averaged 7.3% in all the years in which the Fed pushed interest rates up. This calculation, at least in nominal terms, directly contradicts the popular belief that higher interest rates bring real-estate prices down. When the above calculation is repeated using the *real* price of housing instead of the nominal price, however, the inverse relationship appears. Higher interest rates do tend to depress *real* housing prices, and this can happen without any significant fall in nominal housing prices.

Expressing the price of housing in real terms not only clarifies the interest-rate confusion, it also changes the overall housing picture. The accompanying graph shows the history of the real national home-price index over the past 30 years. Notice how, during the current decade, instead of the continuing rise in nominal housing prices that made everyone so fearful, in real terms there has been a significant decline. Far from a bull-market bubble that has begun to collapse, housing when viewed in real terms has been in a bear market since the beginning of the decade.

Moreover, like the real price of oil, the real price of housing consistently reverts to the norm. In particular, housing prices have a strong tendency to rise when they have underperformed precious-metals prices. The graph illustrates how the real price of housing sticks to a steadily rising trend over the long haul, occasionally diverging from this trend but afterwards reverting to it. According to the same data, the real price of housing was 30% above its norm as recently as 2001.

Since that time commodity-price inflation has escalated, and nominal housing prices have lagged far behind. The graph suggests that housing prices are now 30% below their equilibrium in terms of the precious-metals benchmark. Any further decline in the ratio plotted in the chart would transcend the bounds of historical experience. The last time that housing prices underperformed the precious-metals market as dramatically as this was in the 1978-80 period, after which they bounced back dramatically.

We can also calculate from these data the average speed at which the real price of housing has historically converged toward its norm. It shows that norm reversion is virtually complete after three years.

All of these various empirical reasons challenge the popular view that housing prices will remain weak because they are in the throes of a "correction" from "bubble" levels. On the contrary, housing prices are weak only in the sense that, after outperforming commodity prices in the late

1990s, they have fallen behind since 2001. History suggests that housing is significantly undervalued, and nominal housing prices have a lot of catching up to do over the next few years.

Housing prices are thus much less enigmatic than they seem. The nation's wealth and its permanent income are growing consistently, and housing is the largest of all the capital asset vehicles in which wealth can be lodged. At the national level, housing prices are not bounded by the growth of wages or other forms of conventional income. Nor are they subject to "irrational" booms or busts. Instead, they respond perfectly rationally to inflationary forces that drive other capital assets and commodities. The real value of housing is much more stable than the currency unit in which housing prices are expressed.

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