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Other Voices

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A New Realty Crash? Unlikely Soon

As we are near the 10th anniversary of the last real-estate peak, it is instructive to look at the differences – and the similarities – between then and now.

Although much has changed, some recent headlines sound eerily similar to those of a decade ago. Has the real estate market learned from the past, or could we be venturing into bubble territory once again?

Just as in the 2006-07 bubble, buyers are paying spectacular prices for commercial properties and trophy homes. The Waldorf-Astoria in New York changed hands in February for just shy of $2 billion, the highest amount ever paid for a single hotel, while the Willis Tower in Chicago was sold this spring for $1.3 billion, the highest price ever paid for an office building outside of New York.

Commercial property prices in major U.S. markets, as measured by Moody's and Real Capital Analytics, have exceeded their previous peak by more than 30%.

According to an April article in The Wall Street Journal, at least 37 homes in New York, Miami, and Los Angeles have sold for $30 million to $50 million over the past five quarters, up from 14 during the peak of the last bubble.

These price increases have been fueled by investors' search for yield in a low interest-rate environment and by foreign investors seeking a haven and diversification. This has led to record prices, which might be unsustainable, in segments such as Manhattan luxury condos. Some see this as a sign that U.S. real estate is repeating its climb into bubble territory and is headed for another crash.

A look beyond the headlines reveals a different picture. On the residential side, home prices have risen at a slow, steady pace outside of the high-end luxury market, but have not fully recovered from the downturn. According to the S&P/Case-Shiller Composite 10-Home Price Index, as of July, home prices remained 15% below their April 2006 peak.

Meanwhile, new-home construction has also not recovered from the downturn. At an annual rate of 739,000 units, new single-family starts are 60% below the 2006 peak and roughly 25% under the average of the past 15 years. The supply of existing homes for sale today is lower than it was in 2000, while the population has grown more than 14%. This has led to shortages in some markets, which support increasing home construction and higher prices.

The scenario is similar for commercial real estate outside of core markets. Prices have increased steadily since the crash, but remain below peak levels. New development has languished over the past eight years, despite solid gains in the economy and job market.

While U.S. gross domestic product and household consumption are almost 10% above their pre-recession peaks in real terms, commercial real-estate development remains more than 25% below its prerecession peak. This has led to improved property fundamentals, with both occupancy rates and rents rising.

The headlines may be reminiscent of the bubble era, but in many ways the real- estate market is healthier and better positioned than it has been at any other point in the past decade. The excessive leverage of the prior cycle is absent. Buyers of commercial property are routinely putting up 15% to 20% in equity, as opposed to 10% or less during the last cycle, and credit under-

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writing of debt is more disciplined and conservative.

While prices in select sectors and markets may be stretched, the fundamental conditions that might lead to a crash have diminished.

During the last bubble, property values and sales were propelled to historic levels by the rapid expansion in residential and commercial mortgage financing. Residential credit is much tighter today, and sales and mortgage originations are well below peak levels.

Relative to rents or incomes, median home prices are in line with long-term averages. The price-to-rent ratio is similar to that of 2002, and 20% less than it was in 2005. The price-to-income ratio is now where it was in the early 2000s, and about 20% less than the 2005 level.

Commercial real-estate fundamentals are similarly healthy. Vacancy rates are at or near all-time lows for apartments and warehouses, and are at their lowest postcrisis point for office and retail properties. With commercial construction generally still slow on a national level, and with steady jobs growth in the U.S., conditions should remain favorable over the next several years.

It's also important to consider the potential impact of the China slowdown and the strengthening dollar on U.S. property values. Although still uncertain, it is likely that geopolitical issues will continue to drive global funds seeking relative stability into U.S. property, particularly in the major markets. This will help support valuations in these markets.

This economic recovery has been uneven and not as strong as many expected, but the steady, moderate pace has allowed for a rebound without a buildup of imbalances.

Real estate has been underdeveloped over the past decade. Property prices have appreciated to historic highs in some major markets and property sectors, but generally the increases have been far more modest.

Pent-up demand and economic growth will continue to underpin the real estate market. For investors, the message is clear: Nearly 10 years after the bubble began, they will find a chastened and more disciplined market in which to participate.

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