UPDATE
June 2, 2003

Bubble Trouble?
Your Home Has a P/E Ratio Too

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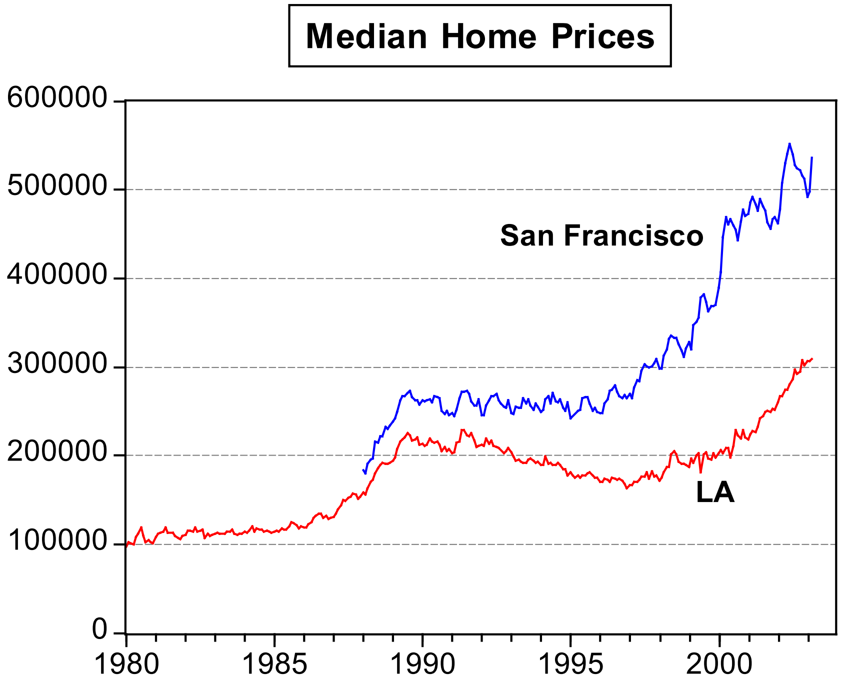
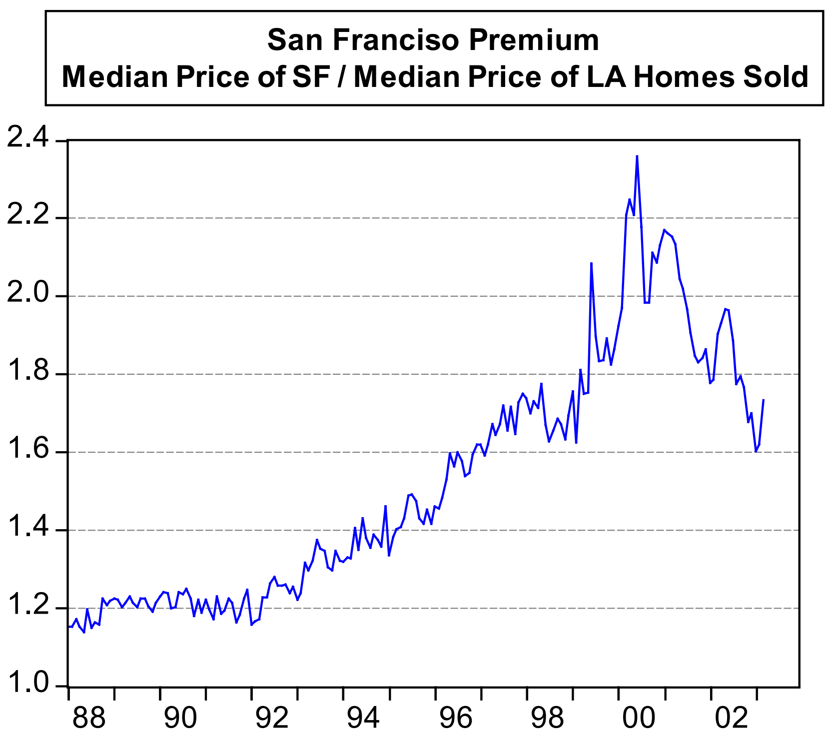
In June 2002, I issued a definition of a regional housing bubble: home price to rent ratios that elevate without support from the underlying fundamental: the rental value. Just as in stocks, a high price to rent ratio is justified in regions where rents can be expected to increase substantially in the future. But be very wary of regional markets with elevated price to rent ratios but weak future economic prospects. That, I argued, was the San Francisco Bay Area, which as of a year ago had a weak rental market currently and prospects for weak rental market for some time to come, but a strong asset market (strong home prices). That's a bubble.

Now a year later, it's time to take another look.

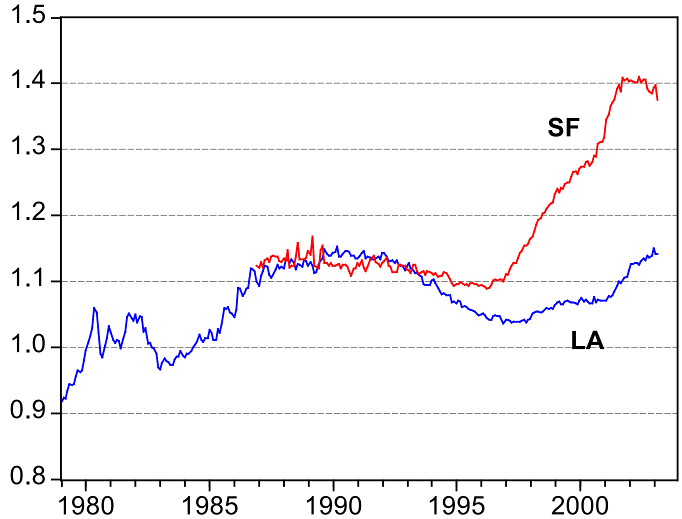
Median Home Prices in San Francisco remain elevated



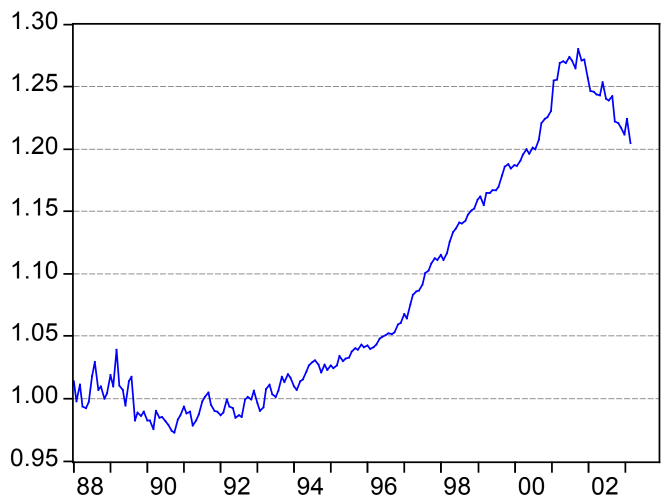


But the Bay Area rental market is soft

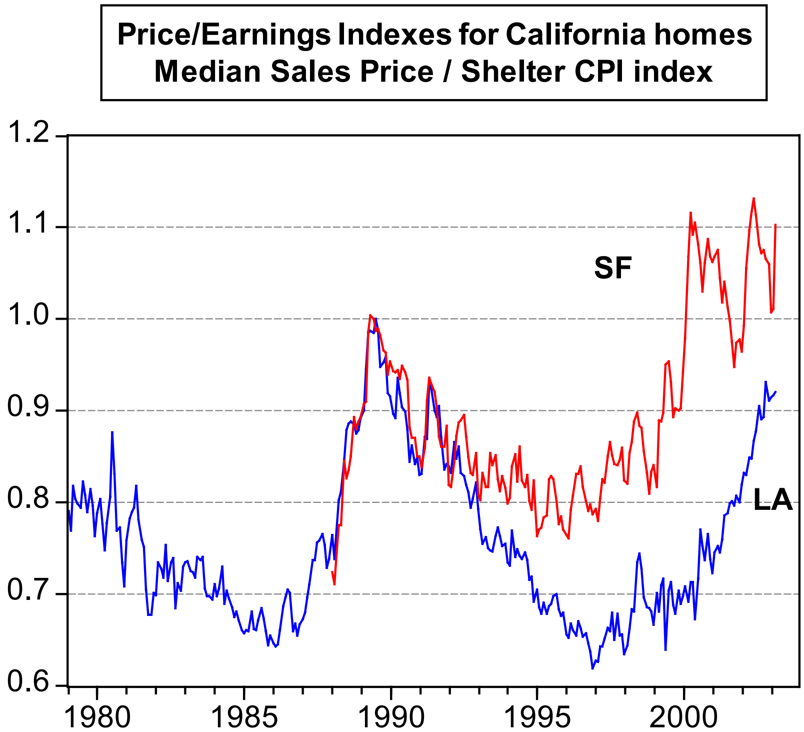
Real Rental Rates
Shelter Component of CPI / Overall CPI



San Francisco Rental Premium
CPI Sheter SF / CPI Shelter LA



And Bay Area P/Es remains elevated, though LA is catching up

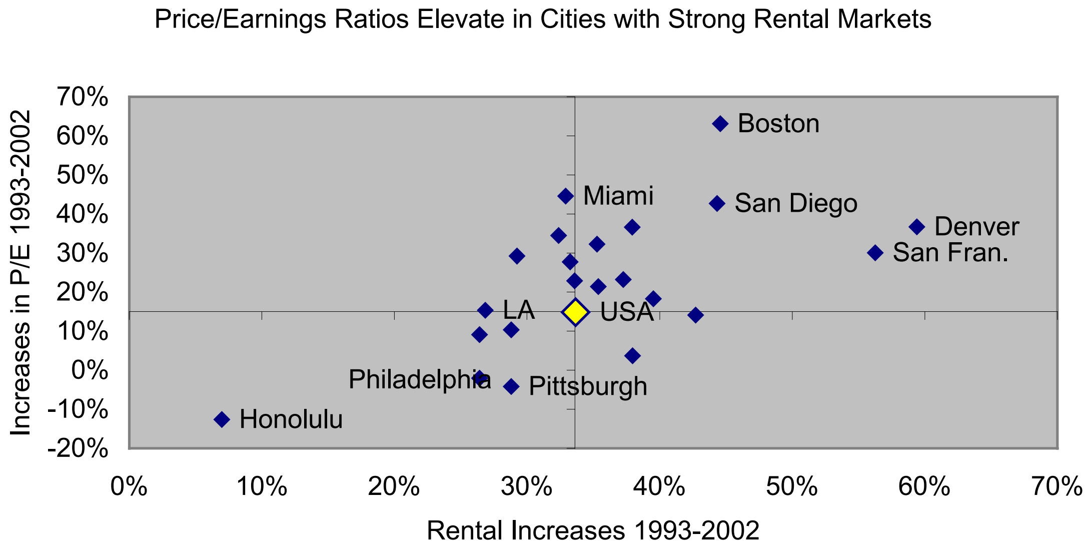


Interpretation:

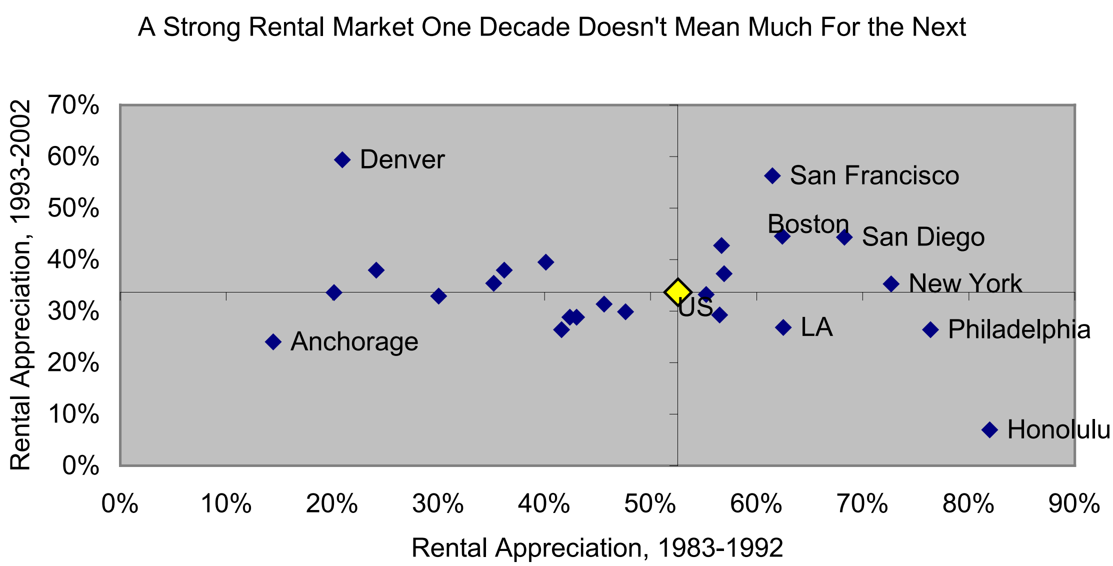
The price premium for the median priced home in San Francisco increased from 20% at the start of the 1990s to over 100% in the year 1999. That appreciation of SF prices compared with LA prices was supported by the fundamental of a relatively strong rental market since rental rates in San Francisco increased by 25% over LA rents. But since the dot-com collapse, rents in San Francisco have stabilized while rents in LA continue to increase.

The bottom line is that SF has an elevate P/E ratio but a week E market now, and for some time to come. That's a bubble. But keep in mind a housing bubble doesn't burst but only slowly deflates. Expect a long agonizing decline in prices like we had in LA in the early 1990s.

Price/Earnings Ratios Elevate in Markets with Strong Appreciation of Rents



But don't count on getting support for that elevated P/E in the next decade



Interpretation:

There is an overshooting problem with asset prices amplifying swings in rental values, which swings are not sustainable because of the regional competition for business.