September 2005

DAVIS HAMILTON JACKSON & ASSOCIATES

The Sky Is Not Falling

I suppose that it's about time for us to weigh in on the possibility that a prick in the housing "bubble" will lead to a crash in that sector and bring this current expansion to an end. We will ignore the temptation to argue whether or not there is a bubble. Let's just say there appears to be something of a bubble in certain markets, although Houston, Texas is not among them.

Plenty of evidence exists that easy money has been made by individuals leveraging themselves to own multiple houses as investment vehicles. Clearly, speculative activity has been flourishing, aided by bankers eager to build assets while the Federal Reserve was providing lots of money to the system at a cost of almost nothing.

In certain areas, prices have been bid up to the point that rentals don't even come close to the cost of carrying the property. If there is to be a crash, these are the areas at risk.

A bit of perspective is in order. First, much of the speculation is concentrated in resort communities and major cities like New York and San Francisco, which have no way to effectively expand supply. It is notoriously difficult to get permits to develop property in Hawaii or coastal California. The environment has been such that bankers have been providing money on easy terms to speculators who use the properties as collateral. They have been very clever in creating new mortgage instruments to facilitate this speculation.

As long as the regulators do not change the mortgage rules to discourage this type of borrowing, this could go on for a long, long time. That is, it could continue as long as institutional investors in the secondary market for mortgage pools remain willing to buy these newly created instruments.

But, the antibodies are beginning to form. Bank regulators are discussing changing the rules so that a loan for a property not owner-occupied would have to be treated as a commercial loan and would be judged on its cash flow, not the collateral of the house itself. It's about the same as changing the margin requirement for stocks. The result will be less money for speculation in the housing market.

Also, the secondary market for mortgages is becoming to be a bit more inhospitable. Fannie and Freddie are no longer able to grow their mortgage portfolios to the sky. Mortgage resellers are finding that demand from institutional investors for their paper is waning. Profit margins for reselling mortgages are being squeezed.

Will all of this lead to a crash? I doubt it. If speculation diminishes in the supply constrained areas there may be some correction from current asking prices. But as there effectively is no new supply in these desirable areas, the greatest likelihood is a long period of flat to slightly down prices. That is what has happened before. Most of the country will remain relatively unaffected, since most of the country hasn't really participated in the bubble.

This is not to say that public companies in the banking, mortgage, or homebuilding businesses won't be affected. These companies have enjoyed the wind at their back for years. Now the wind is in their face. At a minimum, these companies can not grow their earnings at the rate they have enjoyed for the last five years. In all probability earnings growth will be much harder to come by for the next several years as the "bubble" eases back to normal.

Instead, economic growth will come from other sectors, i.e., Energy, Capital Spending, Defense, etc. The economy of the United States of America is large, strong, and resilient. We've survived a savings and loan bubble in the Seventies, an energy bubble in the Eighties, a technology bubble in the Nineties, and we'll survive the housing bubble of this decade. The sky is not falling.

Meanwhile, stocks seem likely to suffer their seasonal late August/September correction as Sentiment is disturbingly bullish. But valuations are not severely stretched and most companies have already guided expectations downward after very robust earnings reports in the second quarter. Downside for the S&P 500 is probably no more than 5%.

After the correction, it will be more apparent that neither high oil prices nor higher short-term rates will cause a severe downturn. The market will have its usual party around yearend when the Federal Reserve is likely to end this monetary tightening.

Our thoughts and prayers are for our friends in Louisiana, Mississippi, and Alabama as they dig out and rebuild from the ravages of Hurricane Katrina.

Robert C. Davis, CFA
September 1, 2005

A copy of our Form ADV, Part II is available upon request.
FIVE HOUSTON CENTER 1401 MCKINNEY ST., SUITE 1600 HOUSTON, TEXAS 77010 PHONE: (713) 853-2322 FAX: (713) 853-2308