Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

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Thoughts on Economic Trends

In any type of long-term investing it's important to recognize the economic effects of events and trends so that you can invest accordingly. You want to position yourself to benefit as changes in supply and demand cause reallocations of resources in the economy. This month I'll highlight some important trends and events and analyze the implications for investors. Specifically we'll look at the effects of the following:

- Baby Boomer generation retirement
- Increased oil prices
- Runaway health care costs
- Interest rate cycles
- The election in the United States
- Recent hurricanes in Florida

I don't claim to know the precise timing of the effects on prices; rather my intention is to provide guidance for long-term investors.

Baby Boomer Retirements

The term Baby Boomers refers to the generation born between 1943 and 1960. The oldest of this group is just starting to retire and, as more and more do so, they will cause big shifts in the use of the nation's resources. While there are many consequences, I will focus on one aspect with big implications for real estate prices: where people will choose to live in retirement. Retirees tend to favor warmer climates and are concerned with ensuring that they can sustain their lifestyle on the wealth they have accumulated. Although many will stay where they are, there are compelling reasons for large numbers to migrate from high cost coastal cities to Florida, the Southwest, and California desert areas.

Since I am based in San Francisco, I will illustrate the likely effect on Bay Area house prices. House prices in the Bay Area have risen far out of proportion to incomes so that currently only 14%[1] of households could afford to purchase the median priced home with a 20% down payment. Prices have risen to this level because the supply of

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[1] According to the California Association of Realtors as of June 2004.

houses for sale has been small relative to incremental demand in the market. I.e. people with very high incomes (or large amounts of capital) relative to the general population are buying up the limited supply. Dropping interest rates have also contributed to incremental demand by increasing new buyers' dollar purchasing power. There are also indications that some of the demand has been from speculators rather than end users – especially in San Francisco. The resulting run-up in prices has caused a correspondingly large increase in the wealth of the pre-existing homeowners in the form of home equity. Many people are sitting on hundreds of thousands of dollars of home equity which constitutes the bulk of their net worth.

Those still in the work force are unlikely to sell and become renters – even if they believe the market is peaking. But what about those who are at, or nearing, retirement? Many of these people are doing the math and figuring out how much better off they will be by selling. They can pull their capital out of the overpriced (and therefore risky) Bay Area, and buy a bigger house in a lower cost location such as Phoenix or Palm Springs. They can then invest the vast bulk of their capital in assets that produce income and thereby enjoy a higher standard of living. As more and more Boomers retire to take advantage of this location "arbitrage", they will take larger and larger amounts of capital out of the Bay Area housing market – and increase the supply of houses for sale. Although the Bay Area experienced an exodus after the dot-com bust, most of those moving were younger, more mobile workers who didn't have much capital to take with them. This time is different!

Of course there will always be more people who want to move to the Bay Area to take the place of the retirees, but the important thing is how this translates into dollars of housing demand. My thesis here is that there will be no corresponding capital inflow to take the place of the fleeing retirees. Most people purchasing a home for the first time in the Bay Area over the next 10 to 20 years will be the post Boomer generations and they will need to finance their purchases with large mortgages. I believe that mortgage rates have gotten about as low as they can go and thus we cannot expect further drops in interest rates to boost the purchasing power of buyers. The bottom line is likely to be a net outflow of capital from Bay Area housing. Over the long run this will mean flat to declining house prices[2]. I expect similar effects in all areas where median house prices have gotten out of line with incomes unless there is net in-migration of retirees.

Real estate in the retirement communities will benefit from the influx of capital from the Coast. As retirees migrate, service industries will follow to cater to their needs. Communities' growth will include both retirees and workers in the service

[2] This forecast is meant in terms of real prices – after adjusting for inflation. If there is a huge inflation in the U.S. as there well may be (given the easy monetary policy that was in effect for so long), then nominal house prices may well rise as inflation boosts incomes more in line with housing costs.

industries: retail, health care, entertainment, construction, etc. Thus both housing and investment properties will increase in value in the target retirement communities.

Higher Oil Prices

Higher oil prices are here to stay. Supply cannot be easily increased and demand just keeps growing as developing economies increase their use of energy. Higher oil prices are like a tax increase on the economy. In particular, it raises the cost of transportation (commuting). All other things being equal, the value of residential property close to jobs will increase relative to properties further away. Taking a macro-economic perspective, the increase means lower investment, lower economic growth, and a declining dollar. On the positive side lower investment should have a dampening effect on interest rate increases. Another likely consequence of permanently higher oil prices is that Texas should prosper, with its concentration of oil industry expertise. A significant shift of resources into exploration and oil services technology will boost incomes and jobs in Texas and thereby benefit real estate owners there. This effect may take years to be felt.

Runaway Healthcare Costs

Healthcare costs continue to increase by double digits year after year and absorb more and more of U.S. economic output. Boomer retirements and the new federal drug entitlement ensure that this trend will continue for the foreseeable future. Because most companies subsidize employee healthcare premiums, increases in these costs boost labor costs. This, in turn, increases the incentive for productivity growth. Eventually this will force many low skill industries not tied to location to move offshore. Companies can also compensate by moving to lower cost U.S. cities such as Phoenix, Las Vegas, or anywhere in Florida or Texas. In contrast to higher oil prices, I would expect higher health costs to result in more business investment as companies seek to increase labor productivity through capital investments.

Interest Rate Cycles

In the last year we've seen oscillation in the long-term rates – 5 years and up. These longer term rates are more important to today's economy than the short term rates (Fed Funds) controlled by the Federal Reserve. The Fed Funds rate mostly impacts corporate investment and is much less important to consumers who account for the majority of national spending. The reason for this is that consumers have become dependent upon the ability to refinance and pull equity from homes to spend. Rising long-term rates discourage this as do rising short term rates. Rising short rates (Fed Funds) directly reduces income available for consumption for consumers who borrowed at short term rates (adjustable rate mortgages, home equity lines and credit cards). In fact rising short rates may cause a spike in bankruptcies in over priced markets (San Francisco, Orange County) where people had to take adjustable rate mortgages to qualify for large enough mortgages.

The rise and fall of long rates may indicate that a feedback effect from reduced consumer spending is keeping a cap on long-term rates. Whenever rates rise, consumption and the economy slow down and this results in reduced demand for investment capital and a drop back in rates. On the other hand the oscillation could also be driven by the tendency of countries running trade surpluses with the U.S. to invest their dollars in U.S. treasury bonds – thus reducing interest rates for all of us. If we really are in an era of capped interest rates then this is very favorable for real estate. The biggest risk to real estate values is a sustained rise in long-term interest rates.

The Election

John Kerry favors higher taxes on upper income taxpayers and on capital. Republicans will likely control at least one branch of congress so nothing will pass (except perhaps an extension of some tax cuts for middle income taxpayers) and most of the Bush tax cuts will expire. Given the prospect of deadlock, I would expect no other changes to the status quo. I predict that Mr. Kerry's proposed $1.7 trillion spending increase (over 10 years)[3] will be cut down to just offset the tax increase ($860 billion[4]) and the deficit will remain high. The implication is that economic growth will slow as the less efficient government sector's share of the economy rises. This should slow real estate appreciation rates but not enough to be noticed by anyone. After-tax returns will be lower to the extent that investors decide to recognize taxable income in a higher tax environment.

George Bush will likely extend tax cuts in his 2nd term and fix the looming social security funding shortfall by diverting money to private accounts. Lower taxes will keep growth higher and lead to slightly better appreciation and liquidity in the real estate market. The social security fix will amount to borrowing money from foreigners at super safe U.S. government borrowing rates and using the money to increase investment in the U.S. and abroad. To the extent that these investments have returns higher than borrowing rates (and they should) the U.S. disposable income will increase over time. This effect will be very gradual and will have no noticeable effect on real estate until the first participants retire in 30-40 years. In the near term though, the increased leverage and investment in the U.S. economy will boost investment real estate values. There will be minimal effect on interest rates.

Florida Hurricanes

The huge destruction of capital wrought by 4 hurricanes will cause a boom in investment and state economic activity. Real estate will benefit from higher occupancy and rising rents. The $25 billion in insured losses will decrease insurance industry capital and therefore capacity. At a minimum the result will be a halt to recent premium

[3] Based on an analysis of the 70 Kerry spending proposals by the American Enterprise Institute for Public Policy Research. The National Taxpayers Union Foundation put the 1st year cost at $226 billion. Both studies were based on a combination of Kerry campaign estimates and independent 3rd party estimates.
[4] This tax increase is relative to what taxes would be if the Bush tax cuts were extended. He actually proposes to reduce taxes by $400 billion from the "pre-Bush tax-cut" tax levels by reenacting the cuts for the "middle class" brackets.

reductions and this could re-ignite the big increases seen after 9/11. This will lower net operating income and cash flow nationwide. Prices should be unaffected for a year or more since most buyers won't recognize the cost increase coming until it shows up in historical operating statements.

Conclusion

Our economy is complex, and while precise forecasting is difficult, smart investors look at the big picture and position themselves to benefit from observed trends. The big picture economic analysis presented here favors investing in low cost sunbelt cities in locations close to jobs: especially in Florida, Texas (Houston), Arizona, and Nevada. Avoid real estate dependent on industries vulnerable to shifts to lower cost locales. In the aftermath of the recent hurricanes, Florida real estate is a good bet; beware of underestimating insurance costs when making investment decisions. Don't let the coming election delay you: the impact on real estate will be minor and long in coming. Recent pullbacks in interest rates indicate less risk of big rate rises than history would seem to suggest.

Featured Investment Opportunity

This is a 4-plex with an extra (illegal) unit in Desert Hot Springs just north of Palm Springs CA. The asking price is $329,000 and 80% residential financing should be available at 5% interest only fixed for 5 years. Assuming the seller pays closing costs you'll need just $73,000 including working capital for this investment. I predict return on equity will exceed 15%.

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280 Tokyo phone: (080) 3122-9601		Single Family Home Investment: RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332