Harry's Take

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Another Take on Real Estate Bubbles: Price to Rents—Where U.S. and Especially California Look Better

Bubbles always end up in an orgasmic phase where things just go up exponentially with almost no relationship to fundamental values. Late 1998 to early 2000 is the classic example in tech stocks. Another example is 1988–1991, the first great real estate bubble of our era, in Japan.

And bubbles ALWAYS defeat themselves from their own extremes—like when there are fewer and fewer people who have the incomes to buy at highly inflated prices. That's why one of the key indicators I have tracked in the past is simply price-to-income ratios. The average price–to–average income ratio shows more of the overvaluation on the high end. In contrast, the median price–to-income ratio shows the strain on the everyday household.

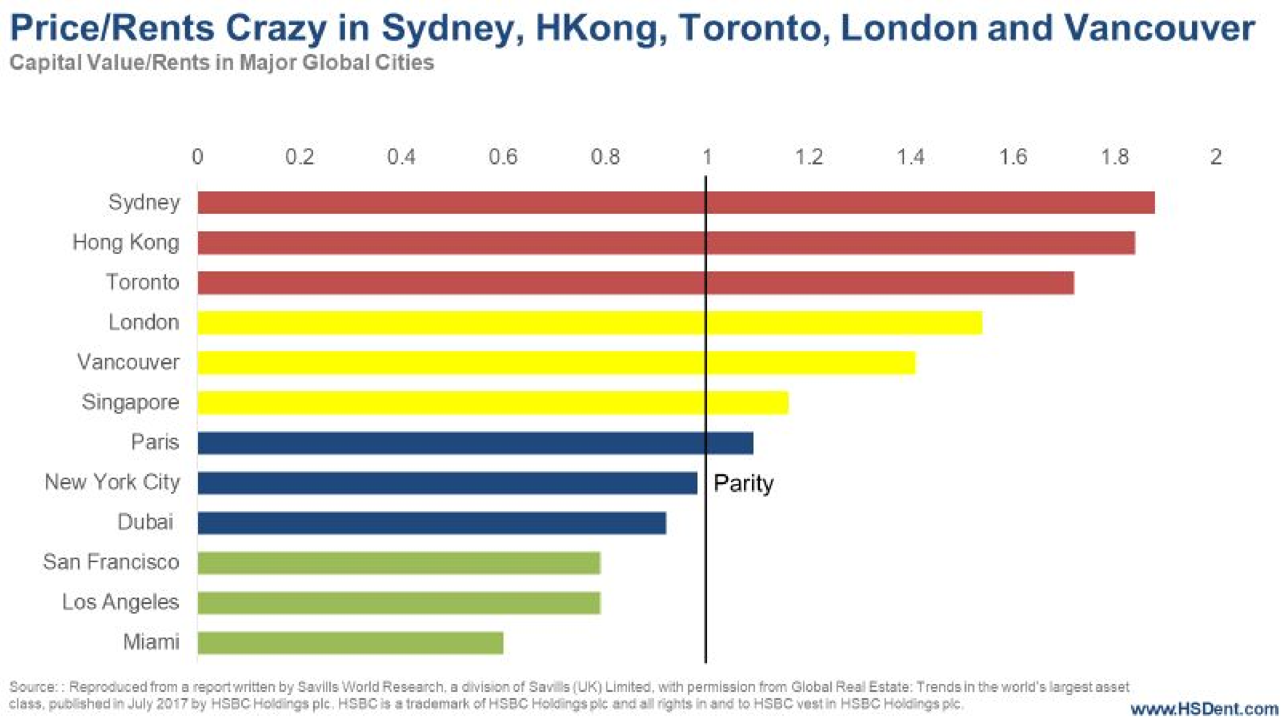
By that median measure, Hong Kong takes the cake, at a whopping 20.9 times income. What? Twenty-one years of income to buy an everyday house? The classic ratio is more like 3 or 4 times, tops! China is the most overvalued, followed by Australia, then Canada, California in the U.S., and the U.K. Vancouver actually tops the list among western cities, at 12.6

times income, followed by Sydney at 11.7 times. Those places make San Francisco look tame, at 8.8 times income.

This latest real estate bubble is showing its extremes more around the world than in the U.S. We got clocked last time around, as did Spain and Ireland.

But reports from British multinational investment bank HSBC Holdings, Inc., use yet another fundamental indicator: price to rents. During my 22 years in California, from 1980 to 2022, landlords increasingly rented out at negative cash flow, hoping to make their nuts on the appreciation in the bubble. (That's called negative gearing.) That way of doing business was certain to fail at some point, and of course it did, during the 2008-2009 Great Financial Crisis (GFC). Obviously, real estate prices hold up better in a bubble crash if rents are stronger compared with prices, rather than vice versa, just as happens when incomes are stronger.

After the last crash, California rents grew faster than prices or capital values. The extreme ratios of prices-to-rents are now happening more among the East Asian nations, as this chart of the top global cities rated by HSBC shows.



Sydney tops this measure at an extreme capital values–to-rents ratio of 1.88, followed closely by Hong Kong at 1.84. Note that using a median price–to-income ratio, Hong Kong is almost double, at 20.9 vs. 11.7. Toronto beats Vancouver in this chart, at 1.72 vs. 1.41, even though Vancouver wins in price to income. Sydney and Toronto have had the craziest ratios of capital values–to-rents since 2012. London comes out higher on this measure as well, at 1.54. The biggest surprise is that rents now exceed capital values in San Francisco and L.A. at a below-parity level of 0.79! If you are a landlord, this is clearly a big warning signal, but it's also a big signal to the overall markets.

The clearest insights are that China, Australia, Canada, and the U.K. come out the worst on both of these measures combined and that the U.S. comes out the best—and I am forecasting that the U.S. real estate bubble will crash 40% to 50% this time.

My view is simple: given the rapid aging of the populations in developed countries and this rare real estate bubble, real estate prices will return to following inflation or replacement costs and rental values. The value is in the rent monies you can get over time or the rents you can save by buying, not in the potential bubble appreciation…. We will not see another bubble like this for a long time, and when it does happen again, it will focus more on emerging countries, especially those in South and Southeast Asia, where the demographics and productivity trends are better.

So, decide quickly what real estate you really want (or don't want) to keep, as the next crash will be much more global and deeper than the crash of 2006–2012. I would take properties in Los Angeles over those in Sydney or Toronto but would sell all those in the most highly valued coastal markets.

More on this in the future.

Harry

Got a question or comment? You can reach us at info@hsdent.com.