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THE DECISION TO INVEST

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The Economics Behind the US Market

Much has been reported and written about the collapse of US housing market values. Villains have been identified, bail-outs have been negotiated, and banks have new, more stringent lending rules. Media reports have focused on banks foreclosing on homeowners unable to meet their mortgage obligations, and for families who have lost their homes, it has been a cruel time. There is no doubt that since September 2008, foreclosures of distressed properties have been one of the prime investment opportunities in the United States.

So what is the situation at the writing of this book? Those Canadian investors looking for opportunities in the US real estate market will find that they do exist. But how is the market different than three years, a year, or even six months ago? A lot of factors indicate that while there are still opportunities in this market, they are decreasing. The lesson for the savvy investor is to work fast before they dry up. But first, let's look at some of the fundamentals behind today's US real estate market.

WHAT TRENDS ARE DRIVING THIS OPPORTUNITY?

- Because of the economic crisis, people are defaulting on their mortgage payments and their homes are being foreclosed.
- Homebuilders, bruised by the faltering economy, were caught between slowing business and increased availability of vacant homes; in 2012, for the first time since 2005, US residential construction is expanding according to the US Census Bureau.

- While people have lost their homes, they still need somewhere to live, and because of that, the rental market in the United States is exploding.
- Baby boomers from Canada and the northern states are looking to migrate to warmer states like Florida and Arizona. To put this into perspective, 34.5 million people live in the northern United States and might soon be considering life without having to shovel snow!
- Global economic uncertainty acts as a catalyst for investors to look abroad for opportunities.

NO INCOME, NO ASSETS, NO WORRIES!

The economic catastrophe we've endured over the last few years can be traced to several conditions that combined to make the "perfect storm." One of these was the subprime mortgage crisis caused when lenders gave mortgages to home purchasers, many of whom who did not have the means to qualify. In some cases, no proof of income was required and mortgages were given for more than 100 percent of the purchase price (housing values were often inflated so the banks could lend out even larger amounts of money), giving rise to the infamous NINJA loan (no income, no job, no assets). To make it easier for people to get loans, banks offered forty- and fifty-year mortgages, negative amortization loans, and "no document" loans. In some cases, purchasers were encouraged to add the value of a new car or plasma TV to their mortgages. It didn't matter if the purchaser had a job—the bank was going to loan them the money anyway. Banks put anyone and everyone into a home, fuelling the "housing bubble."

We all know that the sand that the housing and mortgage industry was built on shifted, and the market collapsed, leading to the merger of Bear Stearns with JPMorgan Chase, and the bankruptcy of Lehman Brothers and numerous small US banks. In addition, the US mortgage insurers, Fannie Mae and Freddie Mac, had to be bailed out by the United States government and remain under the conservatorship of the Federal Housing Financial Agency.

When the market crashed in 2008 and the banks came calling for their money, few people had the funds to pay. With house prices dropping up to 100 percent in some areas, the phenomenon of *negative equity* appeared—where homeowners owed more money on their mortgages than the actual

value of their homes. Called the *underwater mortgage*, this term became familiar to the many mortgagors who borrowed money, bought houses, or refinanced during the housing boom.

Another consequence of the availability of cheap financing was that builders kept building homes. The end result was an oversupply of houses, especially in the states of Florida, Arizona, Nevada, and California. One of the main reasons for the oversupply in these particular states is that home builders expected baby boomers to move to these warmer states in droves. This over-building was another accident waiting to happen when the crash came, and contributed to the decline of housing prices.

HOW BIG IS THE FORECLOSURE MARKET?

From September 2008 to April 2012, there were 3.6 million foreclosures across the United States. People continue to default on their mortgages, and there are presently 1.6 million more homes in “shadow inventory”—homes that could be foreclosed because they are technically in default. Together, Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) now hold over 250,000 foreclosed properties.

At the beginning of 2012, more than 11.1 million US homes (or 22.8 percent of all mortgages) had negative equity, and an additional 2.5 million borrowers had less than 5 percent equity, or were considered near negative equity. The total mortgage debt outstanding on properties in negative equity is \$2.8 trillion; Nevada has the highest percentage of properties with negative equity at 61 percent. According to CoreLogic, Arizona, Florida, Michigan, and Georgia round out the list of the top five states with negative equity.

From an investment standpoint, you may be wondering how long this situation can last, and you would be right to wonder. Foreclosure filings for 2012 are decreasing at a rate of 1.45 percent, down from 2.2 percent in 2010, the lowest point since 2007. In addition, the shadow inventory of 1.6 million homes represents a five months’ supply, down from 1.9 million last year. What’s important for the investor to remember, though, is that prices have dropped by 50 percent and still haven’t recovered to pre-recession levels—presenting an opportunity, for now. And while it may sound like there is a lot of inventory around, it is important to identify the “good” foreclosures, where the market fundamentals add up to a good investment.

KEY INSIGHT

Foreclosure filings are on the decrease, which means that this boom can't last forever. With housing prices still below pre-recession levels, now is the time for investors to act.

THE US ECONOMIC RECOVERY

For the last three years, we've watched as the Federal Reserve printed money as fast as it could in an effort to boost the economy. By introducing more physical currency in the world money supply, the net effect is that the value of each dollar is diminished, and the number of physical US bills worldwide has tripled in the last three years. Why would a government do this? Because it forces the value of its currency down while the actual numerical amount of debt owing on the ledger remains the same. The end result is that the government ends up paying off its debt with money that is worth less. And despite the current downward trend in unemployment, and a growing economy that has avoided a double-dip recession, there remains a protracted economic recovery. The constant politicking by both the Republicans and Democrats, exacerbated by the fact that this is an election year, is distracting the politicians from creating real and sustainable economic growth.

Some positive events are in the forecast too. Some elected representatives are trying to help the public, and a bill was introduced at the end of January 2012 to forgive \$100 billion in mortgage debt. There is opposition to this proposal, however, and it is uncertain whether it will ever pass. In addition, Fannie Mae is trying to get Wall Street back into the property market by offering 2,490 foreclosed homes for sale to larger investors. (At printing, news reports indicate that the first auction has been held and raised approximately \$330 million.) And finally, the Federal Reserve is trying to stem the flow of foreclosed homes coming to market by proposing new regulations that would allow banks to hold and rent foreclosed properties, instead of selling them and depressing prices further.

For Canadian investors, all these factors mean that the door on the foreclosure market remains open for now. But what if any of these solutions, or even new ones, come into play? The market could change overnight.

NEW-HOME CONSTRUCTION

The economic recession has shaken US consumer confidence, but more fragile than consumer confidence is builder confidence. In order for construction companies to build homes, they need customers who can borrow money—and that number has dropped. Builders are also competing with the glut of available homes that are facing foreclosure—they can only build when there is demand. What we are seeing now, however, are builders, who had been on the sidelines waiting for the foreclosure market to evaporate, starting to come back into the marketplace.

The US Congressional Budget Office reported that the annual number of housing starts required to house the growing US population is approximately 1.5 million. Because of the housing crisis, family formation dropped to 600,000 for 2009 and 2010, resulting in less demand for builders' homes. In 2011, family formation increased to 1 million, still below normal. While the drop has caused the “doubling up” of families, it does not mean that the actual demand for housing has dropped—it is just delayed. With the demand being short by nearly 1 million units over the last couple of years, how long will it take until supply and demand come back into balance? We estimate a minimum of three years, and realistically five to seven years.

THE RENTAL EXPLOSION

Another phenomenon has appeared in the wake of the foreclosure epidemic: more Americans are renting than ever before. Morgan Stanley Research, in its paper *Housing 2.0: The New Rental Paradigm* (October 2011), states: “Burned by the worst housing downturn in history, more households are choosing to rent instead of owning a home.” According to the Joint Center for Housing Studies of Harvard University *State of the Nation's Housing Report 2011*, “the number of homeowner households decreased by 805,000 from 2006–2010, while the number of renters rose steadily for six consecutive years, up 3.9 million from 2004.” In Florida, Arizona, and California, we've watched the share of renter-occupied homes grow by 5 percent.

As we said earlier, people may have lost their homes, but they still need to live somewhere. So, while home ownership in the United States has decreased, tenancy is skyrocketing. In fact, according to Reis Inc., the apartment vacancy rate in the United States has declined to 4.7 percent, the lowest since 2001, and we are in the unusual situation where the cost of renting exceeds that of

owning in many areas. We now have a strong tenant market, and for investors looking to get into rental properties, these days are a gold rush.

Investors have been able to buy properties in one of the safest real estate investments—single-family residences (townhomes, apartments, condominiums, and single-family homes)—and earn 6-percent-plus (some as high as 20 percent) returns. This is pretty special, meaning that you don't have to even necessarily factor capital appreciation into your investment decision. The steady rental income from the property provides a cushion, giving you the luxury of time to wait for underlying housing prices to improve.

KEY INSIGHT

The single-family residence is a prime investment, offering a solid income stream for investors, as well as the possibility of capital appreciation in the future.

With the Canadian dollar at par, the largest number of foreign buyers are from Canada, who purchased 24 percent of all residential properties purchased by foreign buyers in the United States. In 2012, 26 percent of foreign investment went into the state of Florida. Other states popular with Canadians were Georgia, California, Arizona, Texas, and New York (Source: NAR). Why Florida and Arizona and the others? For many Canadians, these markets provide a second home opportunity, as well as investments.

Ex-homeowners as Tenants

So, with fewer homes being built, and people needing to rent, where are they going? A brand-new trend is emerging: people are staying in the very homes they just lost to foreclosure and paying rent to remain as tenants.

Let's look at an example of how this works. John is an independent film producer in his early fifties, and is well connected in the movie industry. Over a decade ago he bought a house for \$185,000. In 2003, he received a phone call from his bank, and the bank says, "Great news, John! Your home is now worth \$500,000. And we would like to offer you a line of credit for \$200,000."

Well, John is a single guy working in the film business and he loves his toys. He embarks on a shopping spree and burns through the \$200,000 in no time. He's done exactly what Suze Orman, one of the world's greatest financial commentators, warns against: "Buying things you don't need with

money you don't have to impress people you don't like." John's monthly interest payments on his home and credit line go up to \$6,500—just on the interest alone.

As you may have guessed, this story doesn't end on a happy note. When the markets crashed and the banks called him on his line of credit, John was trapped. His business was in decline, he wasn't making as much money as he used to, and he had no option but to declare bankruptcy. So, at 56 years of age, John has filed personal bankruptcy and has lost his home, not to mention his pride. He put his house up on the chopping block and it sold to the highest bidder for \$153,000.

The proud new owner had purchased the home to use as a rental unit. And guess what? He already had a tenant lined up, ready to move in. And that tenant was John. Yes, the very guy who had to file bankruptcy because he couldn't afford to carry the house at an inflated price, with a line of credit he had no business acquiring or spending in the first place. And John isn't the only guy doing this; it wouldn't be called a trend if it were isolated. This story is being repeated over and over again in the southern United States.

By the way, please don't feel too bad for John; he didn't have to move, and now he's paying \$1,020 a month in rent, a payment that is quantifiably easier for him. And there's another potential silver lining to John's cloud that works for you as an investor.

If an American hasn't owned a home for over three years and has cleaned up his credit record, he or she qualifies again as a first-time home buyer in the United States. So after three years of good behavior, people are free to apply for a mortgage as a first-time buyer, accessing all of the concessions and incentives normally available only to those making their first foray into home ownership. One of the most exciting incentives for people returning as first-time buyers is the down payment. In many places, it's only 3.5 percent with an FHA-insured mortgage (the FHA is the US counterpart of the Canada Mortgage and Housing Corporation, or CMHC). Americans who have lost a home aren't psychologically wired to stay renting forever. So the one-million-plus people who faced foreclosure in 2010 will be returning to the market in 2013 looking to purchase a new home, and they may as well purchase it from you.

Contrast that with the Canadian situation, where it is still cheaper to rent than buy because of relatively high house prices, and where the interest payments on mortgages and property taxes are not deductible as they are in the US.

KEY INSIGHT

Only in America can you own a home, lose it, and three years later be reborn as a first-time buyer eligible to make a minimal down payment. That makes your tenant of today your exit strategy tomorrow.

PRIME PROPERTY WILL BE IN HOT DEMAND

There is another force behind the major social and economic trends we see, including immigration to the States, called “boomer-nomics” (a phrase coined by William P. Sterling and Stephen R. Waite in *Boomernomics*, published by Ballantine Books in 1998). This is named after the demographic of people, the baby boomers, who were born between 1946 and 1964. This group has driven the economics of every stage of life they are at, from the explosive growth in industries like baby food and diapers when they were first born, to the construction of new elementary schools, to new cars and minivans as they started their own families. Now they are focused on their retirement.

There are approximately 85 million boomers in America and 8.5 million in Canada. This phenomenon is not isolated to North America, as we see similar trends in China, Japan, India—really, all around the world.

Play along with us for a moment and pretend that we are playing a game of musical chairs. You remember this game from childhood, where you circle a ring of chairs and wait for the music to stop, which is your cue to sit down before getting left out. The catch to the game is that there are always fewer chairs than there are players, so people push to grab whatever chair they can, and someone is always left in the lurch. With no chair to sit down in, the last person standing is eliminated from the game.

Now imagine this: you’ve got 85 million boomers circling a limited number of chairs. And the music has stopped as the first waves of boomers have reached retirement age. What does that tell you? Get in the chair business!

Prices on prime real estate will begin to increase as it begins to be acquired. Growing demand will drive up market value. If this is true, if boomers are going to rush to purchase and live in prime real estate for their retirement, then doesn’t it make sense to invest in the places that people are rushing to? And this is exactly what’s happening in the US markets right now. The prime spots are going first.

KEY INSIGHT

The US Census Bureau reports that 34.5 million boomers live in the northern United States. What do northern boomers want to do when they retire? They want to get out of the cold. And Canadian snowbirds also want to come in from the cold.

The states hardest hit by the market correction—Florida, Arizona, Nevada, and California—experienced a decline in real estate values anywhere from 35 to 65 percent off peak prices. At the same time, if we look at where retirees have been heading since 1993, we see that these were in fact the exact states that real estate developers were over-building.

What the Bureau of Economic and Business Research Institute at the University of Florida has stated is that 250,000 people are expected to immigrate to Florida annually, right through to 2030. In Arizona, they'll be gaining 1.1 million people in the same time frame, or roughly 50,000 a year heading into that state.

Those numbers are the reasons why builders were keen to develop those areas, and the reasons why many Canadians have been buying up property—because they know that the one thing that is absolutely inescapable is the rate at which we age. Boomers are going to slow down, spend more time with loved ones, and spend more time with their families at a time in their lives when they can afford to. That's boomer-nomics.

In Part 2 we'll look the particulars of the distressed property market, but next let's look at a tool that can help you find the right investment property.