

## End of the so called "Housing Bubble" (7/16/02):

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Many bearish investors have called the recent environment a "housing bubble" because falling interest rates are stimulating excessive consumer demand for real estate, thereby driving up the cost of real estate to unsustainable levels. In some cases this is true. In New York and California, for example, home prices have appreciated 20% + in the past year as demand for new homes and existing homes has outstripped the supply of available homes.

The concern amongst this group of investors is that, if interest rates continue to fuel excessive consumer real estate spending (given their already high level of indebtedness) the real estate market could eventually "pop" and cause economic turmoil for years to come.

In April 2002 I wrote a [U.S. Housing & Remodeling Report](#) examining the housing industry. My conclusion was that interest rates shouldn't surge 150 - 200 basis points in the near future due to weak economic growth. The weak economic growth will be a result of high levels of indebtedness amongst businesses, consumers and the government.

### In the last month my views on interest rates have changed.

After looking at various economic reports and looking at the plunging U.S. Dollar and weak foreign investment in the U.S. I believe interest rates will likely rise in the next year. How much I cannot say but it should be a concern for executives in the homebuilding industry who have enjoyed a huge increase in business due to lower interest rates. I expect consolidation in the U.S. home industry to continue which should help the larger home builders.

Allow me to explain how interest rates might increase in the next year or two, potentially by a lot. I have no econometrics background so I am not even going to try and model the impact it could potentially have on the industry.

I constructed the following .gif file at the bottom after reading the May 7<sup>th</sup> Federal Reserve Comments:

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### Check out my favorite business books:

A timely investment related book to pick up some time. Deflation will become a more common word in the media in the next five years. Find out what it is and how it affect you before it is too late!

*“The members recognized nonetheless that there were upward pressures on costs in a number of areas. These included significant increases in energy costs in recent months, evidence of an upturn in some industrial prices, sharp increases in many insurance costs, continuing upward pressures on medical costs, and modest recent declines in the foreign exchange value of the dollar. With the stance of monetary policy currently quite accommodative, the members saw the need for careful monitoring of the potential for rising inflation pressures as the economic recovery gained momentum.”*

So why should homebuilders be concerned you say?

A weak economy typically correlates with an accommodating Federal Reserve through a lowering of interest rates. The lower interest rates are designed to stimulate investment and consumer spending / refinancing.

However, there should be a huge concern for U.S. homebuilders.

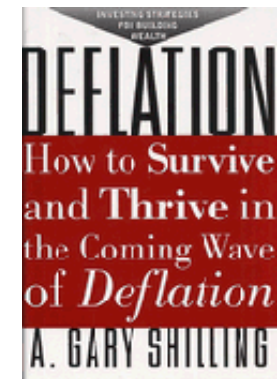
A falling dollar is a double whammy for foreign investors. Take for example the Japanese. Not only did many buy dollars, to purchase U.S. assets, at 135 Yen but they can only get 116 Yen if they convert these assets now. So not only are many foreign investors losing money due to currency translations ( - 14% on currency translations alone) they are also getting negative returns in the stock market. This is causing foreign \$\$\$ to flee quickly.

As the dollar falls it takes more U.S. Dollars to buy foreign goods. As a result of higher prices consumers cut back on their purchases somewhat. This is called "elasticity" because it isn't a 1 for 1 relationship. Higher prices will only result in a certain percentage reduction in end demand.

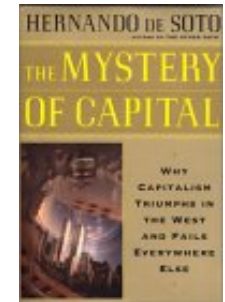
Another possibility is that foreign manufacturers can make less money by leaving prices unchanged.

The key element to understand from this is that, if foreign manufacturers jack up prices in the U.S. it sparks inflation, which means rising interest rates, which is what we don't need right now.....

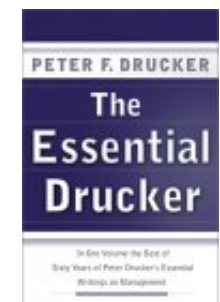
Could the following scenario then occur? I don't know but it is worth evaluating and pondering....



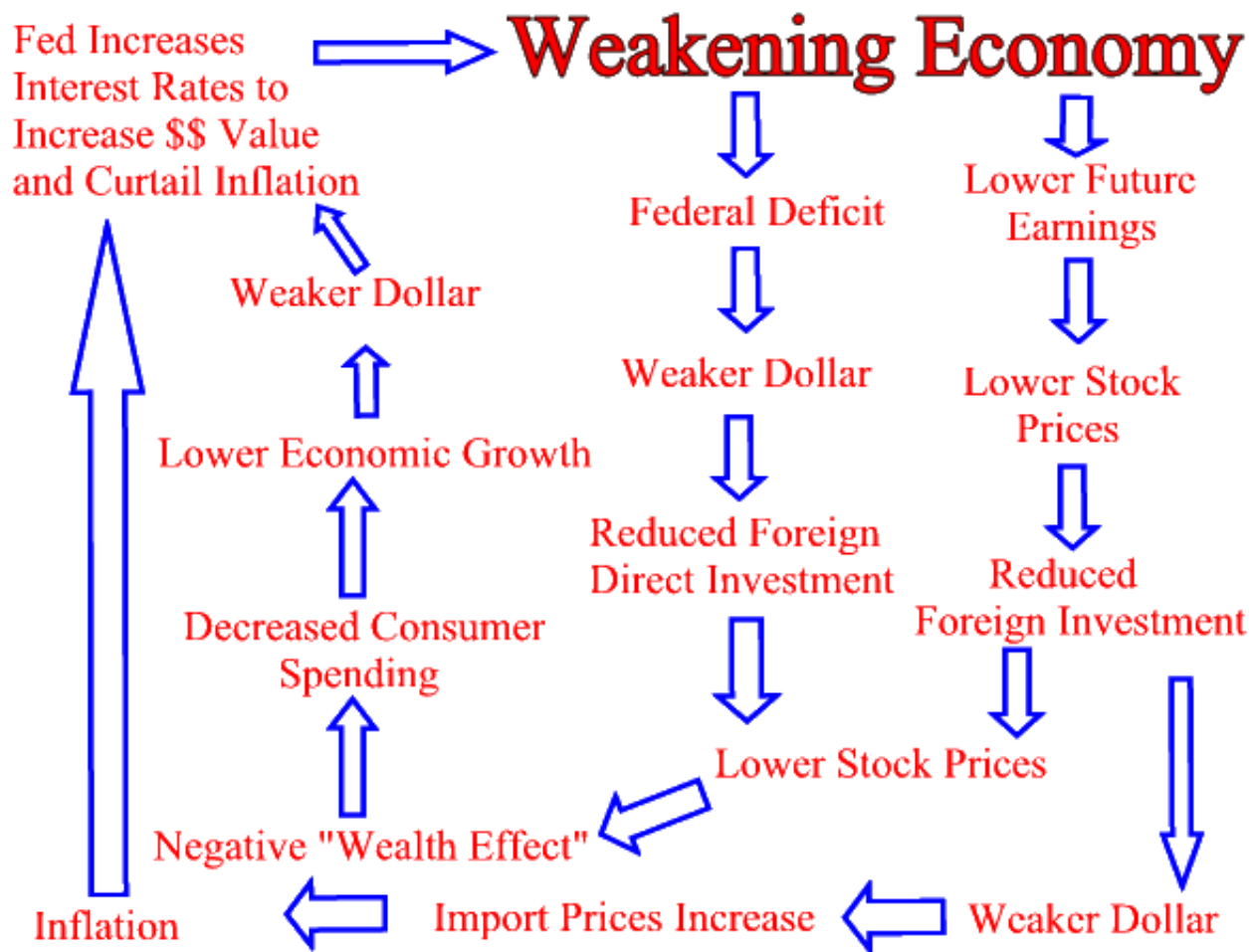
Politicians and economists have been raving about this book since it was published in 2000.



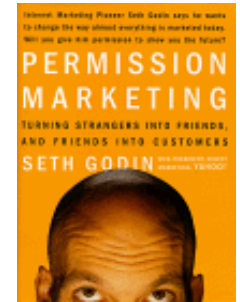
Peter Drucker is regarded as a founder of management as a discipline. This book is a summary of his best work, which spans over 60 years!



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