WILL THE BUBBLE BURST?

By Troy Anderson

In his 75 years of life and business, David Mahmood has built eight companies from scratch—and enjoyed a bird's-eye view of the ups and downs of the stock and real estate markets.

"I've enjoyed the best and suffered under the worst of recessions, and I've learned a couple of simple rules," says Mahmood, the founder and chairman of the Dallas-based private investment banking firm Allegiance Capital Corporation. "What goes up will go down. What goes down will go back up. All bubbles burst. The key is not if, but when."

Mahmood's words of economic wisdom come as a growing number of financial experts are expressing concerns about potential stock and real estate bubbles in the United States and throughout the world.

The stock market soared in 2013, with the Dow Jones industrial average up more than 25 percent and the S&P 500 gaining nearly 30 percent. The Dow experienced its biggest gain since 1996; the S&P had its strongest year since 1997.

Despite a middling economic recovery, investors bid up stock prices to all-time highs in 2013. Experts believe several factors are behind these gains: the Federal Reserve's ongoing economic stimulus program, growing confidence in the economy, and solid corporate earnings.

Many analysts are now forecasting another good year in the stock market—albeit with more modest gains. They note that the ratio of stock prices to projected profits for companies in the S&P 500 index is 15—slightly below the average of 16.2 over the last 15 years and well below the peak of 25 in the late 1990s and early 2000s. These analysts say that stocks aren't overpriced yet and reject concerns that a stock bubble is forming.

Housing Market Concerns

A somewhat similar scenario has unfolded in the nation's real estate market. Just as the stock market has recovered from its deep plunge during the Great Recession, real estate prices have likewise rebounded in many parts of the country.

But as home prices have risen rapidly over the last couple of years, especially in states like California, Nevada, and Florida, a number of housing experts have raised the specter of a real estate bubble too.

In December, Nouriel Roubini, an economics professor at New York University's Stern School of Business who correctly predicted the U.S. housing bubble and its collapse, expressed concerns about "signs of frothiness, if not outright bubbles" in housing markets in Switzerland, Sweden, Norway,

Finland, France, Germany, Canada, Australia, New Zealand, the United Kingdom, Hong Kong, Singapore, China, Israel, Turkey, India, Indonesia, and Brazil.

"What we are witnessing in many countries looks like a slow-motion replay of the last housing-market train wreck," Roubini wrote in a column for Project Syndicate. "And, like last time, the bigger the bubbles become, the nastier the collision with reality will be."

Bubblecovery

Jesse Colombo, a *Forbes* contributor and economic analyst recognized by the *London Times* for predicting the global financial crisis, believes the economic recovery is actually a "Bubblecovery"—a fragile, prone-to-popping economic recovery driven by central banks inflating bubbles in the U.S. housing market, healthcare and higher education, technology, global bonds, northern and western European housing, China, Australia, and Canada.

"What I've been saying is that the Federal Reserve and other central banks are creating an economic recovery, but it's driven by bubbles," Colombo says. "Bubbles create economic growth, and it turns out that the last bubble cycle from 2003 to 2007 was a 'Bubblecovery' as well. We had another recession in 2001, right after the dot-com bubble popped. Alan Greenspan reduced interest rates, creating all these jobs and an economic recovery, but it was based on a bubble. I believe we are doing the same thing again with all these new bubbles. But when these bubbles burst in the future—perhaps over the next few years—the economic damage is going to be far worse than it was in the last economic downturn," Colombo says.

"I think it's going to be far more serious, unfortunately," Colombo says. "We're starting from a much weaker base. This next crisis is coming on top of the 2007–2009 crises, but the world has much more debt now. Part of the reason we've had this recovery is because the governments still had borrowing power and fiscal stimulus programs. This time around, our hands will be tied."

Stock Market

In a recent *Forbes* column—"Why Stocks Are Undoubtedly Experiencing a Massive Bubble"—Colombo noted that stocks have been in an "inexorable bull market that not even the Eurozone crisis, the U.S. debt downgrade, the Fiscal Cliff, rising levels of poverty, and this past summer's bond and emerging market plunge could put an end to."

"After a half-decade of this seemingly paradoxical situation, investors are becoming conditioned to ignore risks and the warnings of skeptics," Colombo wrote. "I appreciate bull markets like any normal person, but I want it to be predicated on sustainable growth rather than a speculative bubble that will end in heartbreak. Unfortunately, I believe that the current bull market has devolved into yet another bubble."

In a recent report entitled *2014: Debunking the Bear Case*, Savita Subramanian, head of U.S. equity strategy at Bank of America Merrill Lynch, projected that the S&P would rise to 2000 by the end of the year.

"With the S&P 500 hitting record highs, and with most of 2013's gains having come from multiple expansion rather than earnings growth, we hear that stocks are now expensive," Subramanian wrote. "We disagree. The S&P 500 is trading near 15x forward earnings, a demonstrable rise from its cycle lows, but is only now approaching its historical multiple, even excluding the frothy Tech Bubble years. Moreover, even if interest rates rise for the next few years, they are likely to remain near the lower end of the historical 2-15 percent range for a while; real rates, along with low levels of inflation, have typically coincided with elevated multiples of earnings."

Dan Caplinger, The Motley Fool's director of investment planning, also believes stocks can head higher from current levels. Considering inflation, Caplinger notes that the S&P 500 hasn't yet recovered to its highest levels of more than 13 years ago.

"On an inflation-adjusted basis, the record highs from that era were around 1,979, giving the S&P almost 10 percent upside from current levels," Caplinger wrote in his article, "Stock Market 2014: How Much Higher Can Stocks Soar?"

Housing Market Bubble in Texas?

Meanwhile, some real estate analysts have expressed concerns about a developing real estate bubble.

In a recent Trulia report, the authors of the online marketplace for homebuyers, sellers, renters, and real estate professionals wrote that national home prices are about 7 percent undervalued. During the most recent housing bubble, prices were as high as 39 percent overvalued in 2006. After the bubble burst, prices fell to being 15 percent undervalued in 2011.

"So despite recent price increases, home prices nationally remain undervalued relative to fundamentals and are much lower than seven years ago—making today's price gains a rebound, not a new bubble," the authors wrote. "At the metro level, prices are above their fundamental value in only eight of the 100 largest metros. Even Texas (metropolitan areas), which largely avoided last decade's housing bubble, are less overvalued today than at their peaks during the last bubble."

Zillow estimates that home values nationwide will rise 4.6 percent this year, compared to a projection of 2.1 percent in the Dallas-Fort Worth area and 2.6 percent in the Houston region.

Of the eight metropolitan areas where home prices are overvalued, three are in Texas. These areas include Austin, which is 7 percent overvalued; San Antonio, which is 5 percent overvalued; and Houston, which is 2 percent overvalued.

Svenja Gudell, the director of economic research at the online real estate database Zillow, says she isn't as concerned about a housing bubble in Texas as she is about those in California (including San Francisco, San Jose, Los Angeles, and San Diego) and Oregon. In some of these metropolitan areas, median home prices have increased by more than 20 percent over the last year.

"We certainly are concerned with some parts of the country that are starting to heat up, and there is a potential for housing bubbles," Gudell says. "Most of them are in California. Portland is also on the watch list. We've seen incredible home value appreciation in those places."

Texas, though, has had a different experience, Gudell says. Texas experienced the housing bubble quite differently from other parts of the country.

"You didn't have quite the run-up and drop-off as other places did," Gudell says. "When you look at the U.S. as a whole during 2003–2006, you certainly had a mild run-up in Texas. This is more pronounced in Austin, but you never really had the collapse after the housing bubble. Prices went down in Houston, and you saw a mild dip-down in Dallas."

Since 2007– 2008, Gudell says, it's been "smooth sailing in Texas."

Austin, Houston, Dallas

"In the last year or two, there has been a pick-up in prices, especially in Austin, where home values have gone up and the housing market has really picked up," Gudell says. "But I don't think Texas is anywhere near a housing bubble."

In October, the median price of a Houston home was $176,400, up 9 percent from $162,100 a year earlier, according to the Texas A&M University Real Estate Center. During the last housing bubble, the median price of a Houston home peaked at $160,100 in June 2008 – falling to a low of $130,900 by January 2009. Since then, home prices have increased 19 percent.

In Dallas, the median price of a home was $189,300 in October, up 12 percent from $166,700 a year earlier. During the run-up in home prices, the median price of a Dallas home peaked at $169,100 in June 2007, falling to a low of $138,300 in January 2009. Since then, home prices have increased 27 percent.

These increases are higher than the national average during that time, which was a mere 12.5 percent increase. Looking forward, Zillow estimates that home values nationwide will rise 4.6 percent this year, compared to a projection of 2.1 percent in the Dallas-Fort Worth area and 2.6 percent in the Houston region.

Jim Gaines, a research economist at the Texas A&M University Real Estate Center, doesn't believe that Texas is experiencing a real estate bubble. "While we've seen significant price increases lately, I don't think we're in a bubble—at least so far," Gaines says. "What we *are* doing is making up for lost time. We had very little price appreciation for almost four years. That being said, there may well be, at the very, very local level—neighborhoods, subdivisions, and individual communities—places where there might be a little bit of a bubble going on in the sense that the market is so hot in those areas that prices are being pushed higher than what normal price appreciation would indicate it ought to be."

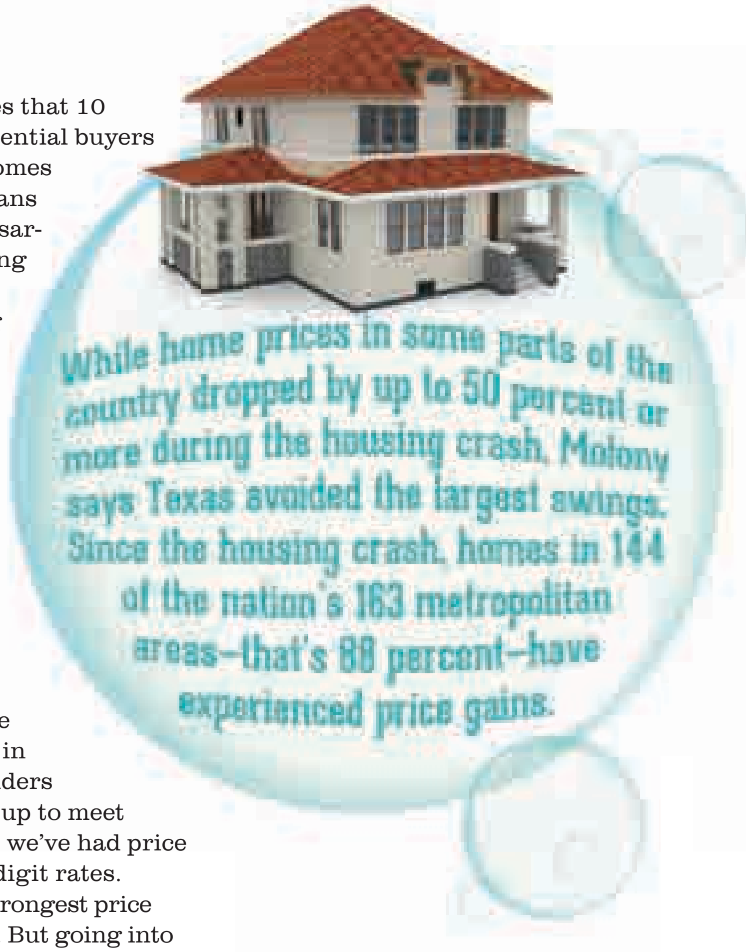
Gaines says he believes the real estate market will even out this month, correcting the imbalance in rapid price appreciation over the last year.

"We've had an extremely active market with very strong price appreciation," Gaines says. "You can't call it a bubble just yet, and we really don't think it's going to be a bubble. Another reason why we don't think it's a bubble is because home prices and income are still in line. The ratio of home prices to income is still staying in the range of what we would expect. It's a bubble when people start paying excessive multiples of income for their housing."

Different Housing Landscape Now

Walter Molony, spokesman for the National Association of Realtors, says the housing crash that began in late 2006 involved conditions starkly different from those of today. That housing bubble was largely the result of the introduction of unstable mortgage products that "induced people into the market who really should not have bought homes."

"We had liar loans; no stated income and money was given to anyone for any reason," Molony says. "It was all a house of cards. Now, we've had the pendulum swing to the opposite side. We have extremely tight mortgage credit. Loans are being denied to otherwise credit-worthy borrowers. Only those with the highest credit scores are getting home loans."



While home prices in some parts of the country dropped by up to 50 percent or more during the housing crash, Molony says Texas avoided the largest swings. Since the housing crash, homes in 144 of the nation's 163 metropolitan areas—that's 88 percent—have experienced price gains.

Molony estimates that 10 to 15 percent of potential buyers who could afford homes are being denied loans because of unnecessarily restrictive lending standards. "At the same time, housing construction is running at half the underlying demand," Molony says. "We went from loose credit and overbuilding to tight credit and underbuilding. We now have a period of tight inventory where we have more buyers than sellers in the market, yet builders are not able to step up to meet the demand, and so we've had price increase at double-digit rates.

"We've had the strongest price gains in eight years. But going into 2014, the market is flattening out. That's good. You don't want to see things rising at double-digit rates for long periods because ultimately that creates affordability problems."

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"The strongest gains tended to be in California," Molony says. "We had gains of more than 40 percent in Sacramento, California; Atlanta, Georgia; Florida; and Las Vegas. We had a lot of double-digit gains in Florida, Arizona, and Nevada. Houston is kind of in the middle of the pack. The gains in Houston are more consistent with the overall national price gains."

Jim McAlister IV, president and chief executive officer of Rockspring Capital, a Houston-based real estate investment firm, agrees that Texas isn't experiencing a real estate bubble.

"In Texas, we have 1,200 people moving here every day," McAlister says. "Meanwhile, our housing inventory has been whittled down to almost zero. It's just in the past six to eight months that developers are able to get loans again. The credit markets are gradually thawing. Everything goes in circles, but it's going to take a number of years just to rebuild to normal inventory levels on top of the population growth. So in Texas there is definitely not a bubble forming."

However, if the stock market plunges again, McAlister and the other experts interviewed for this story agree that housing prices could be impacted. "It might have an indirect impact," McAlister said. "If stocks get hit hard, then people obviously aren't going to be as prone to buying a new house, so that could definitely slow down growth."

Around the globe, Colombo says, real estate prices are increasing—an unsustainable phenomenon driven by low interest rates and rising levels of debt.

"When they raise interest rates again, ultimately it's going cause another pop, not only in the U.S., but also in Canada, emerging markets, and China," Colombo says. "We have not learned from 2008. I hate to say it, but I'm honestly afraid it's going to cause a global depression. I don't see any other way around this with the high levels of debt saturation—not just in the government sector, but the private sector too.

"It scares me. That's why I've devoted my career to warning about these bubbles. I'm an anti-bubble activist, but I'm an investor too and an independent analyst, and I'm trying to wake people up to take action to prevent this crisis. Number 1 is awareness. Without awareness, we are not going to be able to take action in the first place. If people don't believe we have a problem, then they won't be able to execute solutions. I'm trying to get the antidote to business leaders, policymakers, central bankers, and everyday citizens through a grassroots movement I'm building."

Mahmood says government officials are going to play a key role in whether the nation and world manage to navigate through these complicated financial waters without sinking the economy.

"It could get worse, and we could have a bubble burst," Mahmood says. "Washington is going to be playing a significant role. The actions that the government takes in managing the budget, dealing with our financial problems, and getting our financial house in order will play a significant role in what happens. We have a little bit of dichotomy now where we have a booming stock market—and, quite frankly, the underpinning of the U.S., from a financial standpoint, is rather poor."

But looking around the world, Mahmood says, America is still considered one of the safest places to invest.

"I would say we're in dangerous waters," Mahmood says. "Like most Americans, I'm disappointed by the performance of Congress and our government in the way they've failed to manage. So, if we can end up with Congress and the government taking the appropriate remedial actions—getting our financial house in order—I think it will bode well for the markets. If we don't, we will suffer the consequences financially. All bubbles burst. If the stock market falls precipitously and interest rates go up, it will certainly impact real estate."**N**

An award-winning journalist at the Los Angeles Daily News, *the* Press-Enterprise *and other newspapers for 20 years, Troy Anderson writes for* Reuters, Newsmax, Christianity Today, Bankrate Insurance *and many other magazines and online publications. He lives in southern California. For more information, visit www.troyandersonwriter.com.*