



## Home Sweet Home?

*"Real estate cannot be lost or stolen, nor can it be carried away. Purchased with common sense, paid for in full, and managed with reasonable care, it is about the safest investment in the world"*

Franklin D Roosevelt

The old adage says that nothing is certain except death and taxes. I would add one more to that: market cycles. All markets- stocks, bonds, commodity, energy, art, collectibles- move in cycles. Real estate is also a market, but there are several types-industrial, residential, office, retail- and they move in separate cycles....but they do move in cycles.

I want to focus this issue on one area of real estate specifically- residential. In 2015, home values rose in 236 of the 276 cities tracked in the USA by Clear Capital. Places like Miami, Seattle, Dallas, Denver and Pittsburgh (among others) saw almost double the increase in home values in 2015 compared to the national average.

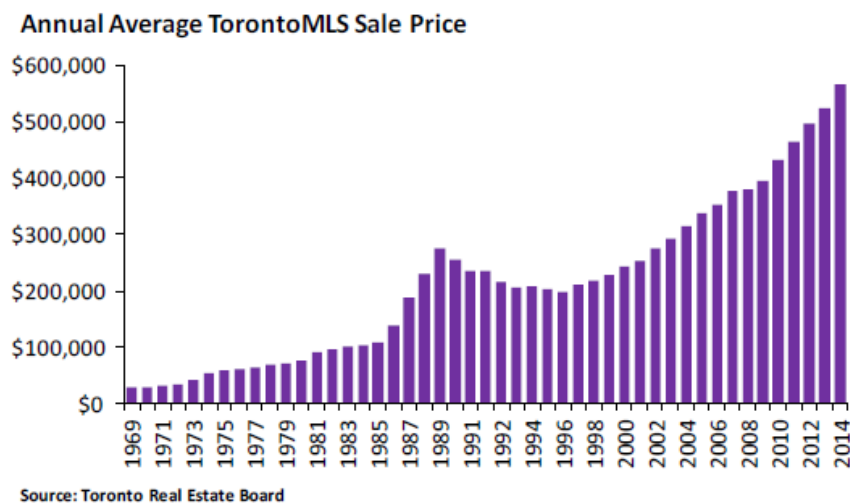
But no centers in North America have been hotter real estate than Toronto, Vancouver and San Francisco.



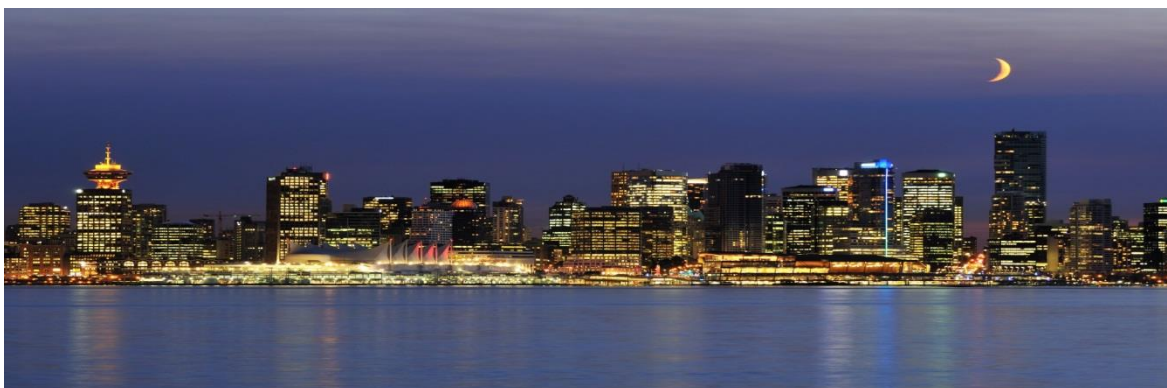
With respect to Toronto real estate, the boom has been due to main catalysts: low interest rates combined with a huge influx of foreign cash. Low interest rates have

encouraged buyers to take on larger mortgages, and this has created a 20-year boom in Toronto.

In 2015 alone, the average price of all property types in Toronto increased by 9.8%, and as of December 2015, the average price of a detached house was \$1,039,638 (source: TREBhome.com)

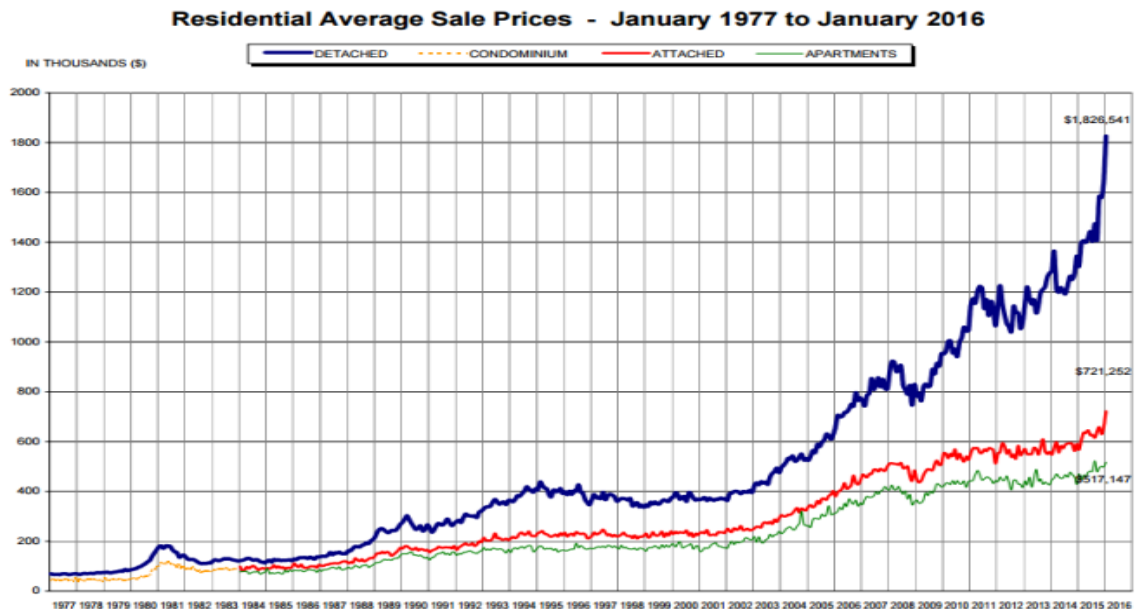


That means that a first time homebuyer with the minimum down payment of \$200,000 saved up (and I think that is being generous) on an average house in Toronto would have a monthly payment of just over \$3,600 per month (\$800,000 mortgage, 2.60%, 25 year amortization- Source: rbcroyalbank.com). I simply do not believe the "average" person has that capability. Now what happens if that interest rate goes up "only" 1% to 3.60%? That monthly payment goes over \$4,000.



In Vancouver, one of the most beautiful cities in North America, the story is very similar. "Build-able" land prices have risen from \$45/sq. foot three years ago to \$116 presently, and if that isn't crazy enough, condo prices in Vancouver are now

selling for an eye-popping \$850 Cdn/square foot (before taxes). That price was \$175 CDN/sq. foot.....but two years ago (source: Gartman Letter March 2016)



Year over year prices are up an astounding 23.2%, with the average residential home now going for \$1,584,110. If the "old" rule of thumb is that the price of a home should cost no more than 3-4 times annual income that means the average Vancouver homeowner would need to have an income of over \$250,000, and I refuse to believe that is the case.

San Francisco has been the USA's hottest market for many years now. Some of the reasons are the same as Toronto and Vancouver, such as low interest rates and a high influx of foreign cash, but San Francisco also has a very limited area to develop, so supply is extremely limited but the explosion of tech startups in the Bay Area has created a whole generation of wealth in an incredibly short period of time.

This photo says it all:



As does this photo of the Bay Area Rapid Transit System (BART):



But.....in March 2016, home prices in San Francisco declined for the first time in four years, according to real estate brokerage firm Redfin. The median dropped 1.8% in March to \$1.25 million, and inventory is up 4% year over year. The situation remains absurd: Only 11% of households in the city can even afford to buy a median priced home, which would require a \$254,000 household income combined with a down payment of \$240,000. The average income in San Francisco is about \$76,000.

This is not new ground for San Francisco. The same types of data and stories about crazy real estate events were similar before the dot-com bust in 2000.

There are two items crucial to San Fran Real Estate:

- 1) Can the tech start up boom get any better
- 2) The mania has created a building boom in the suburbs (which will increase supply available).

My intuition says no to the first and the second will hurt as well. How many more Twitters, Square, Uber , Google, Tesla, Air BnB, Zillow, Craigslist, Drop Box, Fitbit, Pinterest, Splunk, Yelp, Open Table, etc. are going to be created in the next five years?

The beginning and end of cycles, in any sector, are hard to call, but one thing I have learned in over thirty years in the financial sector, is that regardless of the sector, they are symmetrical. By that, I mean when cycles go on for a long time and reach extreme levels, the retrenchment period will also take time and be just as extreme in the other direction. Investors too often expect a short, "needle prick" type painful pause before the good times roll again. And usually they are disappointed. It's that one human trait called "recency bias" I often refer to.

This has indeed been a long and extreme cycle in the real estate markets of Toronto, Vancouver and San Francisco, fueled first by low interest rates and more recently by foreign purchases. Maybe the foreigners will keep buying forever (and maybe China, Russia etc. don't put stringent capital controls in place) or maybe some "Black Swan" event will kick in to keep it going, but when in my daily discussions with Toronto and Vancouver residents get giddy how unbelievable it is....well....it just doesn't feel "normal" to me.

I began this Infomail with a quote from FDR. The important part of that quote are the words "common sense", "paid for in full", and "managed with reasonable care". That's not what is happening right now.

One quote that always has stuck with me for many years was by one economist Herb Stein, who was influential in the Nixon and Ford administrations, who was quoted as saying:

"If something can't go forever, it will eventually stop"

as well as:

"Things that can't go on forever...don't"

And that's all I have to say about that.

Stay tuned,

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