Marathon Strategic News

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Economic Outlook

The Big Picture Looks Good!

This month marks the one-year anniversary ending the worst Bear Market since the Great Depression. Over the past year, virtually all economic data has improved and the geopolitical uncertainties have become clearer. Some positive things that have occurred include: the economy has strengthened (I expect the fourth quarter GDP to be 4%-5%); interest rates have dropped to 40-year lows and have slowly begun to increase; the Federal Reserve has clearly stated that it does not intend to raise interest rates until inflation becomes a concern; taxes have been reduced; corporate earnings and revenues have steadily increased; inflation has remained low; productivity has remained three times stronger than usual; the yield curve is now positively sloped; the cloud of uncertainty in Iraq and Afghanistan has lifted; and the perceived threat of domestic terrorism has diminished. In contrast, the shrinking list of concerns that could cause economic turmoil has been reduced to: the possibility of domestic terrorism; the price of oil remaining high; and to a lesser extent, the federal and local budget deficits. It appears that all fundamental indicators are now pointing toward a continued recovery of the economy and the stock market. In fact, I believe that the economic recovery and the stock market recovery will likely exceed people's expectations in magnitude and duration over the next few years.

Residential real estate prices have gone up for the past 9 years, while stocks have just begun to recover from the worst stock market crash since the Great Depression. Stay diversified, and don't overextend your real estate holdings. Every asset class has a bull and a bear cycle!!

The Current Unemployment Rate is Not an Economic Threat

Historically, declines in the unemployment rate have always lagged an economic recovery, and this economic recovery is no exception. This past July marked the 21st month of the current economic recovery. In July the unemployment rate peaked at 6.4%, and has since decreased to 6.1%. During the 1991 economic recovery, the unemployment rate did not start to decline until 15 months after the economy recovered. Remember, recessions cause unemployment, not the other way around.

Rising Productivity is Good – Not Bad!

Rising productivity is a wonderful improvement to our economy. It means that fewer workers are required to make more goods. The delusional gloom-and-doomers, who say that strong productivity is bad and that unemployment is currently uncharacteristically high, are wrong! It is true that in the short term a few jobs may be cut as a result of strong productivity. However, in the long term strong productivity improves global competitiveness, the standard of living, profitability, and keeps more jobs in America.

Don't Own Too Much Real Estate!

Following the herd and the popular media opinions have often helped to create a false sense of security when dealing with investments. For example, the "New Economy" concept helped to propel the stock market (and in particular internet stocks) to untenable highs. In hindsight we see that the stock market fell from its unsustainable levels to more reasonable, fundamentally-based levels. As I have said before, it is the economic fundamentals that determine the performance and valuation of an investment over the long term.

I believe that individual investors have been similarly lulled into a false sense of investment security in residential real estate. Throughout the recent bear stock market, homeowners have seen their property values increase at annual rates of 4-10% (depending on the location). In fact, the average conventional home purchase price has increased by approximately 70%[1] in the past ten years! There are a number of reasons for such steep price increases. However, I believe that the biggest reason why property prices have increased by such a large amount is a result of interest rates (and mortgage rates) falling to 40-year lows (see Exhibit 1).

Exhibit 1
30-Year Fixed Rate Conventional Mortgages Recently Hit 40-Year Lows

Source: Federal Reserve Bank of St. Louis

Exhibit 2
As Mortgage Rates Increase, Banks will Lend Less and Less Money

	If you Make This Much Money[2]...	...And Current Mortgage Rates Are[3]...	...Then the Most A Bank Will Lend You is ...	...Which Means You can Purchase a House Worth Up To
	$100,000	5.00%	$354,120	$454,000
May 2003 →	**$100,000**	**5.23%**	**$346,320**	**$444,000**
	$100,000	6.00%	$322,920	$414,000
	$100,000	7.00%	$295,620	$379,000
	$100,000	8.00%	$272,220	$349,000
May 2000 →	**$100,000**	**8.52%**	**$261,300**	**$335,000**
	$100,000	9.00%	$251,160	$322,000

Note, calculations are Marathon estimates based on: average US loan-to-value of 78% (Source: CCIM Institute); FNMA & FHLMC underwriting guidelines of 28% maximum front end ratio (front end ratio = principal + interest + taxes + insurance); tax rate is 1.1% of property value; 30-year fixed rate mortgage amortization. [2]Pre-tax income. [3]30-year fixed rate mortgage.

The appraised value of a home is primarily determined by a method called the comparable sale approach. Using this method, the appraised value of a home is determined by the sales prices of similar, recently-sold properties. Since homes are usually sold to the highest bidder the question becomes: *How much would a bidder be willing to pay for a house?* I believe the answer to this question is: *As much as the bank will lend to the bidder!*

The mortgage rate is the largest exogenous variable in determining how much a bank will lend the purchaser of a house (see Exhibit 2). From May 2000 to May 2003 interest rates dropped by 3.3%. This means in May 2000 a person earning $100,000 per year would have been able to bid up to $335,000 to purchase a home. In May 2003 the same person would have been able to bid up to $444,000 on the same house (an increase of 25%). My opinion is that property values went up by 25% from 2000 to 2003 as a direct result of interest rates going down. Further, if interest rates reversed course and went back up to where they were in 2000, then the property values would decline by 25%. After all, a house is only worth as much as someone is willing (<u>or able</u>) to pay for it.

I am not suggesting that real estate prices will fall sharply as stocks did in the recent bear stock market. However, I do not believe it is likely that home prices will appreciate in value over the next several years (I believe that interest rates will be the chief determinate in the stagnation or decrease in real estate prices). From Exhibit 2 we can extrapolate that for every 1% increase in mortgage rates the purchasing power of a bidder goes down by 7.5%.

The decision process involved in purchasing a primary residence is different than that involved in purchasing a second home or a bunch of investment properties. I think that it is prudent at this time for investors to more seriously consider the investment risk associated with real estate. If you own too much real estate, I believe that now would be a good time to rebalance your holding, sell some real estate, and consider increasing your stock holdings.

[1]Federal Housing Finance Board

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