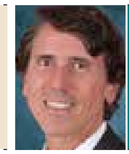

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Home Prices Climb on a Weaker Dollar

In a sluggish economy, don't overlook the inflation factor

The 2007 financial crisis didn't just change how U.S. financial and real estate institutions function, it also changed the public perception of these institutions' liquidity and ability to fund. Before the credit crisis, the mortgage industry appeared to have infinite funding or lending options for residential and commercial borrowers. With then-loose lending criteria and little-to-no focus on documentation, it was relatively easy for mortgage originators to find multiple lending sources for clients.

The situation has changed significantly in the past several years, however. Underwriting guidelines have been tightened up. Mortgage professionals have shifted their focus to finding quality deals that have a realistic chance to fund rather than trying to take as many deals as possible.

Mortgage originators also have seen their ability to access funding changing along with the changes in monetary policies, namely the Federal Reserve's quantitative-easing (QE) policies and the potential tapering of these strategies.

Tapering

By the end of this past year, the Federal Reserve began to cut its monthly asset purchases. This past December, it cut $10 billion dollars from its monthly $80 billion dollars worth of asset purchases. By this past March, after a couple of additional cuts, the Fed's monthly bond purchases were at $55 billion. If this tapering trend continues, will the Fed bring its QE support to zero?

To answer this question and define its impact, it is important to understand the role QE policies played in the past few years. With the Fed being the primary buyer of Treasury bonds and mortgage securities, it helped keep interest rates at artificial record or near-record low rates for several years. On the negative side, QE policies are associated with increasing inflation rates and currency devaluation.

Now, if the demand for Treasury bonds decreases slightly or significantly this year because of a combination of scaling back QE purchases and fewer foreign investments, interest rates are set to rise throughout the year. Subsequently, increasing interest rates may cause fewer borrowers to qualify for mortgages, which again adversely impacts recent home-price gains.

Asset inflation

In the past century, inflation hit the U.S. dollar's purchasing power. Inflation is akin to a hidden tax that can dent the value of any currency. The price of gasoline is a good example of how a weakening currency can lead to higher prices because much of the world's oil supply is traded for in U.S. dollars. Even if the demand for oil-based products falls, prices still may rise because a weaker dollar buys far fewer oil-based products.

With that in mind, home prices have rapidly increased in various U.S. regions since 2010 and 2011 — despite a continued sluggish economy and slow job creation. A stronger job market is one of the main catalysts for a housing recovery, but few would suggest that the U.S. job market is strong today. That is why it is surprising to see double-digit home-price appreciation recently.

With the lack of a solid economic recovery going on in the U.S., similar to the post-World War II housing boom, the question is: What is driving today's home-price appreciation?

The answer: The rapidly weakening dollar that is partly related to increasing government debt, QE policies and bailouts.

Similar to how a weaker dollar buys fewer groceries or less gasoline, it now purchases less real estate. The weaker the U.S. dollar gets in the short term, the higher asset prices like real estate are expected to go. Although real estate typically is considered the absolute best hedge against inflation, this is changing today because of the weak economy.

Foreign currencies

The U.S. population today represents about 5 percent of the entire world's population. A high percentage of Americans have never traveled outside of U.S. borders to experience life abroad. An even smaller percentage of Americans have ever invested in foreign investments such as stocks, bonds or real estate overseas.

More foreign investors from places like Europe, China, Japan, Russia and Australia have been actively purchasing U.S. stocks, bonds and real estate for many years, however. In particular, the number of foreign investors has skyrocketed in the past few years. Chinese investors, for example, are among the biggest investors in real estate in markets across the West Coast, California and New York.

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These investments are driven by the recent turmoil in some foreign currency markets, such as Argentina, Greece, Ukraine and others. Although a weaker U.S. dollar has led to a rapidly declining exchange rate for foreign currencies, it has allowed foreign investors to buy more U.S. real estate with their stronger foreign currencies once exchanged for dollars. A declining foreign currency like that of Argentina may equate to a much lower exchange rate for U.S. dollar, however.

According to a report released by New York's Rhodium Group, Chinese investments in U.S. real estate, oil and gas, and other businesses allegedly surpassed $14 billion in 2013 alone, nearly double the previous year's volume of investments. About 70 percent of these investments originated from private investors or enterprises, as opposed to Chinese-government investments that were more common in the past.

There is a fine line between the U.S. dollar being too strong or too weak and how that pertains to the currency-exchange markets. There may be either a positive or negative outcome related to the extreme fluctuation of currencies worldwide. Only time will tell whether or not the number of foreign investors in U.S. real estate will increase or decrease, depending upon a combination of investors' faith in the U.S. economy, the dollar and their own currencies.

All-cash buyers

One of the primary driving factors behind double-digit annual appreciation in residential and commercial real estate prices is related to the rapidly increasing percentages of all-cash buyers. Many of these buyers are foreign investors. In addition, there are institutional all-cash buyers that comprise hedge funds and Wall Street investment companies as well as individual "fix and flip" or "buy and hold" investors.

In some U.S. markets, the number of all-cash buyers was estimated at around 50 percent to 60 percent of all buyers by the end of this past year. Despite the increase in all-cash buyers, the number of national monthly home sales may be closer to just one-half of historical national monthly home-sale norms.

These declining national monthly home-sale figures are related to the artificially suppressed national home-listing-inventory levels. When demand for a commodity or product such as a home far exceeds the supply, the prices for those assets typically rise. As such, many of the larger banks may have been wise to not flood the U.S. markets with potentially millions of inventory homes at once, which would have depressed prices for many homeowners.

Regardless of whether or not the shadow-inventory supply of homes increases, stagnates or decreases in the near term, banks and mortgage-servicing companies are not actively listing all of their nonperforming home assets for sale to the general public. In many cases, these same banks are selling hundreds or thousands of these foreclosed home directly to institutional investors like hedge funds or foreign investors, which, at some point, may create either a glut of rental homes or of homes for sale.

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Mortgage originators should keep in mind that in the near term, national home-listing inventory levels are likely to remain low despite a sluggish economy, and real estate prices are set to climb even further. If and when the U.S. economy and job market improve, then there may be more stability in the real estate and mortgage industries.

Regardless, foreign investors truly could make the world go round, for better or worse. The supply of capital is also the primary determining factor for the future directions of the housing market. When money is relatively easy and cheap to access, then the housing market tends to boom, and vice versa. ●