

More on housing: price to rent ratios

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What? You still aren't convinced that housing is overvalued right now? Here's another way of looking at real estate that might convince you.

Housing prices divided by rents provides one measure prices relative to fundamental value. I like this measure because it provides a sense for what an investor could earn by buying a house and renting it out. I'd like to think that this ratio fluctuates roughly around a long-run historical norm.

The two graphs below show price to rent ratios for New York City and Los Angeles over the last 20 years. I have also included graphs of annual price and rent increases during those years. Price data are from the **Office of Federal Housing Enterprise Oversight** and rent data are from the **Bureau of Labor Statistics**.



(note that the y-axis is normalized so the actual number means something only in comparison to other years)

Both of these cities experienced similar (but smaller) peaks in their price-to-rent ratio in the late 80s. In the early 90s, New York City and Los Angeles housing prices dropped 10% and 20% respectively in nominal terms. After adjusting for inflation, these price declines were around **40% over 6 years**.

Today's price to rent ratios in NYC and LA are 25% and 50% higher than their late 1980's peak. Unless the US economy takes off like a rocket ship, I'm guessing **at least a 20% nominal price drop in these cities over the next five years**. Inflation-adjusted prices will decline even more.

The other thing going on here is mortgage rates being near 20-year lows. But my calculations suggest that the

difference between 10% mortgage rates in 1988 and 6% mortgage rates today can only account for about a 25% increase in a price to rent ratio.

If mortgage rates can stay low then housing prices might decline slowly over a number of years. If mortgage rates rise (unlikely but not impossible), then watch out. Fortunately the Fed knows this and will keep interest rates low as long as possible (and then watch out for inflation!).

Not every part of the country looks like NYC and LA, but most big cities show similar increases in price-to-rents. The exceptions may be Texas and some parts of the South. **Out of the 24 cities across the country for which data were available, only Houston and Dallas are not at their 25-year price-to-rent peaks right now. Of the 22 non-Texas cities, price-to-rent ratios today are an average of 42% higher than their highest peak in the 1980s.**

At the end of the day, I just don't see most of these cities escaping substantial price corrections. Who knows how it will turn out.

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