Financial News

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Are You Floating On A Housing Bubble?

It's like watching a kid blow an impossibly big bubble. Seeing the pink globe expand past the freckles, past the eyebrows, and even past the shock of messy hair—you wonder what it's going to look like when it bursts.

One of the defining characteristics of a bubble—like the technology bubble of the 90s—is that it keeps growing long after many think it will. And the burst is not a foregone conclusion; even though one kid will end up with gum plastered all over her face, another might see his bubble deflate gently. Everyone is watching the real estate bubble to see if it will pop, slowly lose its air, or keep growing.

Are these real estate values "real"?

Housing prices in some parts of the United States have outpaced inflation by more than 45 percent in the last decade.[1] Just as with the technology bubble, the inflated housing prices are based on a growing demand and perceived value, rather than fundamentals. Simply, people are paying high prices for housing in the belief that the value will continue to grow. Employment levels, income, and even rents have not kept pace with the increase in housing costs. Low mortgage rates and the rapid increase in the value of houses have encouraged prospective homebuyers to keep buying. And so far, housing prices have continued to rise, creating more than $5 trillion in wealth.[2]

Elasticity vs. gravity

Some experts believe it is possible this trend will continue. **Economist Doug Duncan** of the Mortgage Bankers Association believes that housing prices will continue to rise, even if interest rates go up, noting that we've only had a few quarters since World War II when national average housing prices fell.[3] But other experts suggest that what goes up must come down, and housing prices are no exception. **Dean Baker** of the Center for Economic and Policy Research points out that the economy is building more homes than are in demand.[1] This, along with a high vacancy in rentals, could deflate the housing market.

Homeowners "insurance"

If you are a homeowner, you probably count your home as one of your most important investments. Although it may have more personal meaning to you than your stock portfolio, it still carries investment risk and fluctuates in value. In such a low interest rate environment, homeowners are tempted to draw equity out of their homes to pay off consumer debt, finance a remodel, or send a child to college. In taking on more debt, it's important to be aware of the debt to value ratio of your mortgage and not become stretched so thin that you cannot weather a potential drop in your home's value. If you are considering buying a home, make sure you are taking on a mortgage you can manage.

Also, keep in mind the principle of diversification. Building equity in a home can be an important long-term investment, but building one's future on a single investment carries a high degree of risk. Whether you are a homeowner, renter, or someone thinking of buying a home in the future, keep growing your retirement savings. A diversified nest egg can prevent anyone from being caught with gum on their face.

[1] "The Housing Bubble Fact Sheet" by Dean Baker, Center for Economic and Policy Research Issue Brief, July 2005
[2] Ibid.
[3] "Why the Housing Bubble Hasn't Burst" by Chris Isidore, CNN/Money; January 19, 2005

The Rule of 72

Albert Einstein said that compounding was the eighth wonder of the world. It certainly is powerful to watch your investments accrue earnings and then watch those earnings accrue more earnings and so on.

The Rule of 72 is a simple way to estimate how long it will take your investment to double through compounding. Simply divide the number 72 by the expected rate of return. For example, if you were earning 10%, your original investment would double in about seven years (72÷10 = 7.2).

So, let's say you have $30,000 in your retirement account and earn 8% each year. At that rate of growth, your $30,000 would be worth $60,000 in about nine years!* (72÷8 = 9) And, this doesn't include any additional contributions you make going forward.

**This example is intended for illustrative purposes only and assumes an 8% annual return each year. Actual investment returns fluctuate.*

Waving The Wand: How the Fed Wields Its Magic Over The Economy

You've likely seen or heard the headlines announcing the Federal Reserve's interest rate tweaks, and you probably know who **Alan Greenspan** is. But if the details of how the Federal Reserve works and what its chairman does seem a little vague, you are not alone.

Powerful toolbox

Congress created the Federal Reserve System — or Fed — over 90 years ago. The Fed was created to serve as the nation's central bank and was meant to inject order in a chaotic banking system and volatile economy. One of its first duties was to make short-term loans to banks in an effort to stop the national runs on banks (heavy demands for cash by customers) that led to the great panic in 1907. Through implementation of its monetary policy the Fed currently helps promote national objectives such as moderate interest rates, stable prices, and maximum employment. To accomplish these often competing goals, the Fed has some tools it can use. Through open market operations and reserve requirements, the Fed may impact your life more than you realize.

Open market operations

The most important tool the Fed uses is its open market operations. As the central bank of the U.S., the Fed — through its 12-member Federal Open Market Committee (FOMC) — buys and sells government securities. When the FOMC purchases securities (treasury bills, notes, and bonds), it buys them with cash, which injects money into the economy. Conversely, the Fed can sell securities and take money out of the economy. By doing so, the Fed can also manipulate the fed funds rate. This is the short-term rate banks charge for lending their excess balances held at the Federal Reserve to other banks. As the FOMC sells bonds, the price generally decreases and the yield (rate) increases. When the FOMC buys bonds, rates drop. When Greenspan announces a change in interest rates, the FOMC will buy or sell bonds until that target rate is achieved.

Reserve requirement

In an effort to stabilize the country's currency, the Fed also mandates how much cash banks must keep on hand. This is called the reserve requirement. For example, if the reserve requirement is 50 percent and the total sum of deposits at a bank is $20 million, that bank must keep at least $10 million in cash either in its vault or deposited with a Fed regional bank. If the Fed lowers this requirement to 25 percent, more money can float around the economy. When the Fed raises this requirement, a bank has less money to loan and the economy may slow.

Inheriting a legacy

Having served for 18 years, Greenspan is one of the longest-serving chairmen among the past 13 chairmen in history. Some have called Greenspan a magician for using interest rates to grow the nation's Gross Domestic Product while keeping inflation relatively low. Set to retire in 2006, Greenspan will be succeeded by former **Fed Governor Ben Bernanke**.