Real Estate and the Economy
Bad and Getting Worse

By Robert McHugh, Ph.D.
February 1st, 2015

The economy is heavily dependent upon a strong real estate market, especially housing. A strong housing market means jobs, and if prices are rising modestly every year, it also means improving homeowner balance sheets. I do not see housing, both new construction and existing home sales, improving in 2015, in fact I would not be surprised to see it deteriorate from already depressed 2014 levels.

First of all, what I am about to discuss is empirical evidence, not coming from government statistics, which I do not believe for one second. Sometimes the best evidence for future trends is in the trenches, not from a satellite view, and certainly not from a government view. We are morphing into a socialist economy, into a socialist government in America. The amount of regulatory burden is growing and so preponderant as to harm small businesses and individuals, for example in areas such as 1) health insurance (Obamacare as it turns out was really invented to make sure the health care industry had paying customers and did not have to serve too many freebies, such as in emergency rooms, while at the same time making sure health insurers could pass along all their costs to individuals, who are now required to carry health insurance, to even have to attest to that effect on their tax returns. This has impacted the ability of small businesses to hire full time employees, instead forcing them to play games with part-time rules exclusions, which reduces the number of full time workers in America) and 2) in housing, which is the primary subject of this section.

The fact of the matter is, the middle class is slipping away toward upper lower class, and the upper middle class is slipping away toward middle class socio-economic status. A depressed Housing market is one of the key reasons for this.

About one-third of America's population lives between Boston and Washington D.C. along the I-95 corridor. This market includes

Manhattan of course, which was the primary beneficiary of the Fed's QE 1 through QE 4 programs the past five years. $5.0 trillion of freshly printed cash was handed to Wall Street and that money has boosted the wealth of Manhattan, feeding the already rich and creating more good folks who are rich, but has done very little except block opportunities for everyone else throughout the country. We have the rich in Manhattan and in Hollywood, and a few other pockets throughout the country, and what we see is housing valuations in those areas going higher, in some cases through the roof, thank you very much. This is also reflected in elite vacation locations such as the Connecticut, New York, and New Jersey shorelines, where beneficiaries of the QE programs come from Manhattan and purchase beach properties for $1.5 to $3.0 million, many in good shape and not that old, and tear them down for the land so they can rebuild homes that will be worth $3.0 million to $7.0 million when finished. This is nice for them, but is not reflective of the vast majority of America's housing situation. This is fantasy land for Manhattanites but pain for most of the rest of America. Let's explore.

First of all, there is a widening chasm between affordable housing for beneficiaries of the Fed's QE programs and the rest of America. Most elite homes are being priced higher and higher, however the McMansions that were high-end neighborhood homes are dropping in value as qualified buyers are harder and harder to find. Homes that sold in the $600,000 to $1,000,000 range that were the choice of the upper middle class are not interesting enough for the beneficiaries of the QE programs to become buyers for those properties. As a result, most of those homes have dropped in value into the $400,000 to $600,000 price range. This has helped freeze the market for mid-range priced homes in America as many of those homeowners either owe more than their homes are worth, and do not want to risk becoming a short sale, or the homeowners just do not have the stomach to take the loss and relocate or downsize.

But because of the hyperinflation that has resulted from the Fed's corrupt QE programs, corrupt because they singled out a small segment of the population as beneficiaries, while the entire population is left with the unintended (or perhaps intended behind closed doors) hyperinflation in the cost of necessities such as health care, food, transportation vehicles, and the next category I want to discuss, lower-income housing.

A weird thing has happened because of the QE programs. There has been essentially a floor placed on low-end housing, and a cap placed on higher-end (not upper end) housing. The value of low to moderate income housing has risen over the past decade while the value of middle-income and upper middle income housing has declined or stayed flat. In other words, as an example, almost all housing is now valued within a range of $300,000 to $600,000, regardless of true replacement cost of the home. Drive around in suburbia, and what you will see is 50 year old 1,500 square foot ranchers valued at $350,000 by listing agents, and not far from them you can find a 15 year old, 5,000 square foot home with custom design and materials for $600,000. If you compare the price per square foot, the buyer's bargain is in the larger home, however the seller's bargain is in the older, smaller cookie cutter home. The lower home is valued at $233 a square foot while the upper end house is valued at $120 per square foot. Why?

A strange thing has happened in the appraisal world. Some of it has to do with the Dodd-Frank disaster of a bill, that has appraisers so afraid of being wrong about a property's value, that they are no longer doing the cost approach to appraisal valuations, rather they are placing almost 90 percent reliance upon homes that sold within the same school district or locale, the comp approach to appraisal. This penalizes nicer homes, newer homes, larger homes in the appraisal process. It means if there is a dump that sold for $350,000 that is old, small and was built with crap materials, and you own a newer, larger, home built with far better quality materials, the value of your home is held down by the dump that just sold for $350,000. Banks are not willing to ignore the appraisals that are coming in based upon comparative prices for non-comparative homes. They are not able (the Dodd-Frank law prohibits bankers to talk to appraisers) to ask the appraiser to adjust his estimate because the home is larger, is custom, or is newer.

Now, every appraiser in America will tell you they have the ability to adjust the value of a home for issues such as square footage, quality construction, and age differentiation, but in reality, at this time, largely because of the overzealous requirements and fear brought on by

Dodd-Frank (Christopher Dodd and Barney Frank aren't even in Congress anymore, it was just a hit and run by them), they will only tweak an appraisal for a nicer home, maybe by 5 percent, and that is it. Location, location, location in the form of comps is the driving force behind what seller's can expect to get for their homes. Most realtors are onboard with what is going on; they have to. While a realtor can say, no, this is a great home, and deserves to be listed at $750,000, even if they get a buyer to agree, if that buyer is not a cash buyer, then the appraiser will drive the deal. If he/she appraises it at $600,000, and not the $750,000 agreed upon price by realtors, buyers and sellers, the deal will in all likelihood fall through. No bank is going to lend off sales price. They will only lend off appraiser price. Thank you very much Dodd-Frank legislation.

In other words, common sense is taken out of the equation. Why? **To promote socialism. The equalization of all, to reward sloth and punish success.** But here is one of the key problems with this creeping socialism within our government's policies: It only applies to all socioeconomic classes of people except the rich (let's define it properly, something along the lines of passive income over $2 million a year +, with a net worth of $10 million +). They are exempt because of their ability to make all necessities purchases with cash – no need for financing, no need for a job, no need to comply with overzealous socialist laws such as Dodd-Frank. The target for the creeping invasion of socialism in this nation is the middle and upper-middle class.

The other impact here from the new appraisal world is that the value of homes in America cannot increase because it is only cash buyer deals, outside the scrutiny of regulators and legislators, that can drive prices higher. That is why you see shore properties and Manhattan properties rising but not much else is rising in value across America. Most of America does not have cash buyers. Most buyers depend upon financing.

Let's work through the micro analysis of why Housing for most Americans is not only going to be stagnant in 2015, but could get flushed into the johnny.

In spite of the lowest mortgage interest rates in 50 years, housing has been a complete disaster. Both existing home sales and new construction. Ridiculously low interest rates have not been able to revive the housing industry. Look around, drive around, do you ever see a sold sign? You can drive into any neighborhood in America outside the few exception areas such as Manhattan, Hollywood, and a few other high income, high net worth areas, in other words, you can drive around about 98 percent of the geographic area of the U.S. and you will see sales listings all over the place but hardly any sold signs. Why? This doesn't make sense, right? Hey, the Fed just bought the long end of the curve and interest rates are at historic lows in the ten year Treasury. Why hasn't this spurred housing, and all the jobs that come with a normal housing market? What is going on? Let me tell you.

First, is the appraiser issue I mentioned earlier. Dodd-Frank. A real estate market killer. A socialism demon.

Now let me tell you about a real deal killer: The inspector. Now, when you go to sell your house, or even if you go to buy one, most banks and buyers are hiring a so-called independent inspector. In the past, you might be required to have a termite and radon test inspection, and with the appraisal that was about it. Pretty much buyer beware. Deals got done.

But now, there is the Superhero Inspector, an independent party who comes in and goes over the home with a fine tooth comb and prepares a report of findings for all parties, the buyer, the seller and the realtors. Typically the buyer pays for this inspection, and typically the seller is asked to leave the premises while the inspection occurs. These inspections can take as much as 5 to 6 hours to be completed. Pictures of everything are taken, many with a zoom photo lens' to identify cracks or mold in walls, roof tiles, window sills, anything. Inspectors I refer to here are not the local government building inspector, they are usually contractors that have been certified to be inspectors. Many are unscrupulous. They are digging up dirt so they can be hired for more intense detailed follow-up inspections and tests from their initial findings, and in some cases offer the buyer their services to do the repairs. In many cases their findings are false. False positives. But it is enough to kill the deal.

By now you must think I am making this stuff up. I am not. I am deadly serious.

There are at least two new hot buttons that I am aware of, two issues that never before were a problem or issue for the sale of a home. We are all familiar with asbestos. I am not talking about that, although it will be identified in most inspections if it is present in an older home on the market. No, the two new hot buttons I am referring to are mold and stucco/dryvit.

First of all, let's discuss mold. Mold has been around for centuries, for millennia, and never has been an issue in selling a real estate property, never was a deal killer. Mold and mildew are natural byproducts of water and shade. Mold and mildew can be found on the north side of almost every single structure in America. That is just the way it is. Well, of course it is not a healthy environment to live with. No argument there. But neither is too much sunshine. However, the socialist regulations are now targeting mold and mildew as if the seller intentionally wants to poison the buyer, and if you are the owner of a property, you are now expected to clear it all out before you have the right to sell your home. Even a brand new home will have mold on its north side within a year of occupancy. The inspection process is now regulating the required removal of something that is a natural byproduct of living. Instead of buyer beware, or letting the buyer have the personal choice to remove mold from their new home, these inspectors are writing up the presence of mold and mildew in their 50 to 60 page reports about your home that you are trying to sell.

Now get this, these inspectors are looking behind walls, under window sills, cutting through air vents, through electrical outlets, under shingles on roofs, they are moving materials and taking zoom pictures of the presence of this stuff. If they move materials and do not put them back properly, you end up with leaks in your house you did not have before.

Do you understand what this means? Do you understand the costs involved in removing mold and mildew? Exterior siding and shingles have to be replaced, but worse, once those have been removed, then if the sheathing behind has mold or mildew, it has to be replaced too. Windows that are replaced will expose the interior of walls and if mold is found, then a special remedial contractor has to be hired to remove it. This can be a nightmare. This kills deals between buyers and sellers.

The second new hot button for these inspectors is stucco/dryvit. Probably about half the homes in America have stucco or dryvit exterior walls. So, after you have come to terms with your potential buyer, now that you think you have your house sold, the inspector arrives and your realtor will inform you he wants to drill 200 holes through your stucco siding all over your house and he wants to peek inside these holes and dig for mold and mildew. Or for moisture. You get to live with the cracks and damage from the 200 holes he drilled and caulked afterwards. Look, concrete breaths. Water comes through it and dries and goes out. Been that way for centuries. Now all that is gonna change. You have to think the plastic siding industry lobby has something to do with this nonsense. Instead of having a safe, breathing exterior such as stucco, used for centuries, homeowners will be forced to turn to plastic exteriors which do not breath. Is that good for homes?

If the inspector drills 200 holes, and finds moisture, the seller is likely to be asked to allow a more intense inspection where huge sections of your stucco exterior are removed. Try repatching and getting the color to match your house after he is done carving your home up? How’s that for magic.

If it goes this far, as a seller, you probably have a failed deal, and are looking at investing $50,000 or more to get your home in shape to pass a future inspection to a future buyer. If you don’t have a failed deal, probably what happened is the realtors negotiated a new lower price for the sale of the property that takes into consideration the cost to the buyer of repairing everything the inspector uncovered or manufactured. But by lowering the price, the seller has to make sure they are not ending up with a short sale where they are going to receive less than what they owe, which circling back again, could kill the deal.

Now get this: If you think as a seller you can let the deal die, and hope for another buyer with a different inspector, perhaps one that is more reasonable next time, the bad news is that the first inspection becomes part of the listing information and any new buyer will know that you had an inspection that failed, probably scaring off new potential buyers. You, the seller are screwed.

Let’s say you miraculously make it through the inspection process, and the appraisal process, the next hurdle is hoping your buyer can get a mortgage from his bank.

Again, because of Dodd-Frank legislation, which has essentially destroyed the housing market, most financiers, most banks are requiring down payments of at least 20 percent, some requiring has much as 30 percent. Some are willing to do 15 percent if you take out a second mortgage that they will portfolio. But that is one gigantic cash hurdle for most Americans. It can mean parting with most of their cash nest eggs, or not having enough cash to acquire the home. Earnest payments are rising, the amount of money a buyer has to place in escrow for a seller to take their home off the market while the inspection, appraisal and bank financing process is underway. In the event the buyer cannot obtain financing, the seller gets to keep the funds. This can range as high as $10,000 to 20,000 on a $500,000 home. One of the problems with 20 to 30 percent cash down requirements is that in the past, most lower and middle income households depended upon pulling some equity out of their current home to obtain the down payment cash for a new home. As discussed above, that is now a rare event.

If a buyer can qualify for a mortgage, but the bank gets their hands on the inspection report and feels they are not happy with the condition of their collateral, that can kill the deal.

If the buyers are working three part-term jobs because they were downsized in the past five years from a full time job (thank you Obamacare), or are new on their job because of being let go from a prior job, this can cause a bank to say no. Getting a prequalified letter from a bank prior to entering into a real estate sales agreement helps mitigate some of the financing risk. Many realtors now insist upon such a letter for them to broker a deal.

So, at this point, either a rare deal has occurred with all hoops jumped through, or a deal has failed. If the buyer comes along that is a cash deal, then that eliminates most of the trouble above from Dodd-Frank. A seller can simply negotiate away the inspection process as part of the final sales price. But, except in Manhattan and the Connecticut or

New Jersey suburbs or shore, or in places like Beverly Hills, how many potential cash buyers come along for low or mid-level housing? The answer is practically none.

So, if we step back and evaluate if housing can improve the economy, let's go to the next logical step. Our seller decides to stay put, not sell, but hire a gaggle of contractors to renovate their home. Good luck with this. In this situation the local government building inspector becomes involved, giving a permit to construct and renovate, but it also means he will be coming by to inspect. New building codes will have to be complied with. What if your home is old or for some other reason, does not comply with code? Well, your renovation budget just got shot to pieces. If a contractor removes a wall, and the wiring is wrong, guess what, you now need new wiring. What if asbestos is discovered, or mold, or lead pipes or faulty anything. You have now opened a can of worms. The contractor is happy, he gets more of your money, the building inspector is happy, he "gotcha." This is a big problem in Canada as well.

Or try this on for size: More and more localities are declaring old buildings "historic," which limits the type of renovation work that can be done, or if you do decide to renovate it since you are not allowed to tear it down, bingo, you are back into the game of bringing everything up to modern codes. Since these are older buildings we are talking about, chi-ching, renovations could cost you a fortune. This is not lost on potential buyers. If you own an historic home, good luck trying to sell it.

So what happens? Nothing. Sellers stay put, renovations are restricted to minimal emergency work. Housing stays dormant, or worsens, and construction jobs and all other housing related jobs decline. The economy worsens.

Let's look at anther dynamic going on. This one is demographic. This one is from empirical observation.

The young generation of Americans are what I term the "screen" generation. They find pleasure, purpose, self-actualization not in their homes, not in their upscale cars or boats or vacation second residences. They are quite content to live in a small apartment, whether in Manhattan or Scranton, and to drive a small inexpensive car, to dress modestly, to live modestly, to forgo a fancy restaurant. As long as they have a large TV screen, a laptop, an i-pad, i-pod, and i-phone they are good.

What this means is that the baby boomers do not have a ready demographic supply of real estate buyers coming up from behind. It means demand for middle or upper middle income homes is and will continue to shrink. They are perceived as money pits, too inconvenient to maintain, too much of a time robber. Landlords should see an increasing boom in tenants. Leasing will grow in popularity.

So, what we can conclude is that there are two key factors killing housing, 1) a change in demographic preferences, and 2) because of over-regulation, because of the legislative overreaction to sub-prime lending back in early 2000's, low and middle income socioeconomic status folks, the majority of America, Main Street, cannot benefit from the Fed's QE policies and near zero interest rate policies. The economy suffers and will continue to suffer from this spiraling dynamic. Housing will drag again in 2015, and will be a huge drag on the true economy in Main Street America, not the economy you are propagandized is all that matters from the financial media mouthpieces for Wall Street and the Central Planners that tell us how to live our lives.

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Dr. McHugh's book, "The Coming Economic Ice Age, Five Steps to Survive and Prosper," is available at amazon.com at http://tinyurl.com/lypv47v

"Jesus said to them, "I am the bread of life; he who comes to Me
shall not hunger, and he who believes in Me shall never thirst.
For I have come down from heaven,
For this is the will of My Father, that everyone who beholds
the Son and believes in Him, may have eternal life;
and I Myself will raise him up on the last day."

John 6: 35, 38, 40

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