Ashdon Investment Management

The Wealth Effect
&
The San Francisco Housing Market

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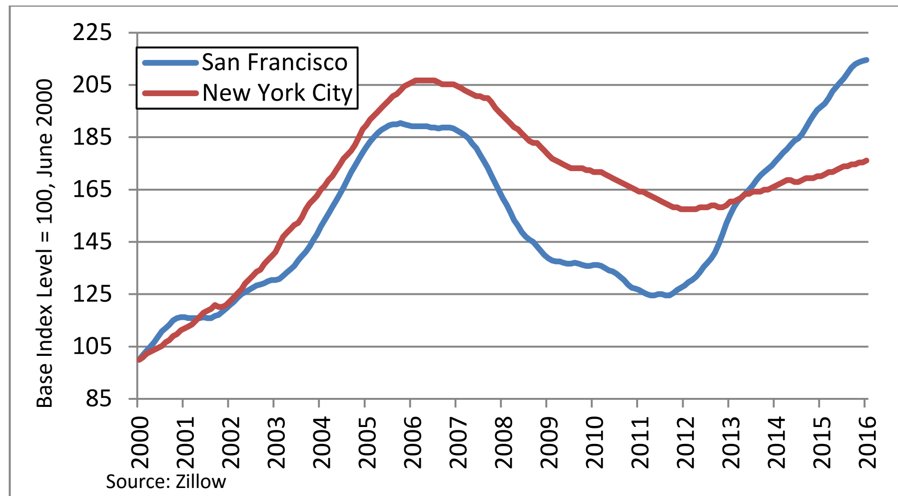
- **A striking difference in the data is that the wealth effect appears to currently have more influence over the Bay area than NYC.**

- **There are severe negative implications on the real economy due to how entangled employees have become to near-term performance of their employers' share prices.**

The Wealth Effect & The San Francisco Housing Market

The wealth effect is a psychological phenomenon that occurs when increasing net worth from our investment portfolios, homes or currency creates a feeling of financial contentment or satisfaction. These feelings cause us to spend more because we feel we can afford it. The wealth effect is an intensely studied phenomenon that has major implications in economic theory.

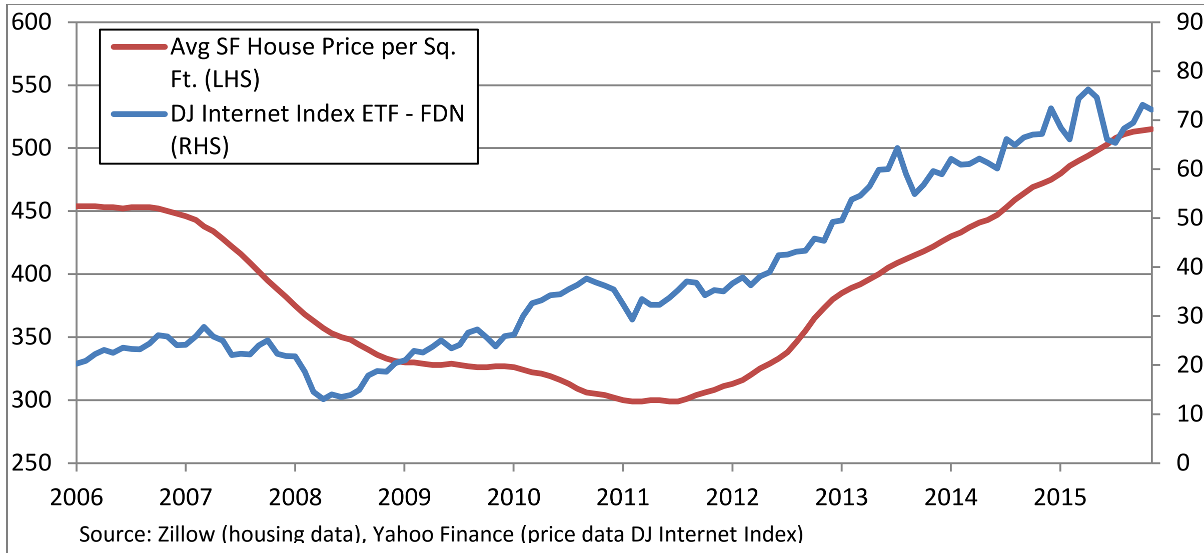
Residential real estate markets have been a strong performing asset class over the last four years. As we all know with real estate, many factors influence the level of prices in a given area. In general, when analyzing real estate markets it helps to see the relative change in prices more than it does the actual prices. Below is a chart of the relative change of prices for residential real estate per sq. ft. since June, 2000, for the markets of San Francisco (Bay area) and New York City.



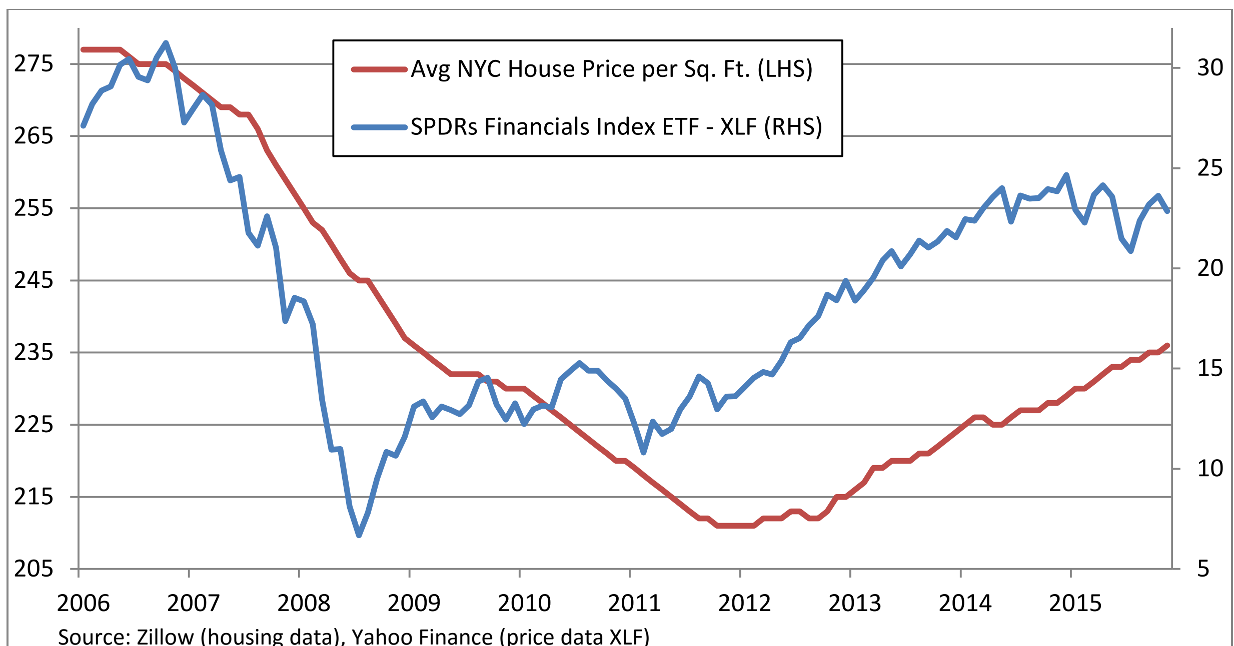
Notice in 2012 that both San Francisco and New York City began to see higher prices, putting an end to the fall-out from the financial crisis. Also notice the rate of change is not equal between the two with SF outpacing NYC nearly 5 to 1 since 2012 (SF 12.3%/yr; NYC 2.2%/yr). This difference in growth rate is likely a tale of two economies.

Since the tech-boom in the mid-late 1990's, San Francisco, although more diversified today, is still the tech and large internet company capital of the world. New York however, classically tied with banking and finance, has not witnessed the same level of growth since the fall-out from the financial crisis.

The chart below is a comparison of the Dow Jones Internet Index (index of internet-focused consumer and business services companies) to the price change in SF Housing per Sq. Ft.



And the SPDRs Financials Index ETF (mega-cap financials index featuring banks, brokerages and insurance firms, mostly based or with large presences in NYC) to the price change in NYC housing per Sq. Ft. is shown in the next chart.



Annualized returns are compared in the following table.

Jan1, 2012 - June 1, 2016	Annualized Return (%)
SF Housing	12.3
DJ Internet Index ETF	17.3
NYC Housing	2.2
SPDRs Financial Index ETF	12.8

SF house prices tracked “local” stock market index returns. However, NYC house prices significantly lagged the “local” stock market returns. What could cause this difference?

A recent article from Bloomberg has revealed local mortgage lending activity that I believe explains the difference quite well. This article gives an account of an upper middle-class employee for Apple financing a seemingly unaffordable home with no money down once “factoring in” compensation received in restricted stock in lieu of cash take-home-pay. The payment in restricted stock was modeled as income today when qualifying for a jumbo mortgage. The down payment (which was too large for the employee to provide) was then issued by the local credit union as a second mortgage with this “income” taken into account.

At the surface this activity seems legitimate, because stock grants (although restricted from being sold for a period of time) carry an easily obtainable market value, and recently, these market values have steadily increased. So much in fact, that compensation via restricted stock units, stock options or outright grants has become the effective carrot for tech firms to hire and retain skilled employees. In contrast, the way finance firms pay employees is usually a base salary plus a *cash* bonus on an annual basis. It is not common practice in any other industry to pay employees with non-cash equity on the same scale internet companies do.

What makes this lending behavior not legitimate (at least for an extended period of time) is the situation it creates - increasing asset prices (company shares) overly influencing other asset prices (homes in the Bay area). It is an inherently de-stabilizing process due to the over reliance on share price appreciation of a handful of firms. For example, the technology industry has proven to be one of the most boom/bust industries in history. What happens when industry fundamentals deteriorate and/or investors indiscriminately sell internet company shares?

Outright declines in share prices could force the region into a recession. Due to the high leverage characteristics of these mortgages, even a minor market correction would shake the confidence of lenders. The marginal housing demand, being suddenly forced to pay unaffordable cash down payments, will rationalize housing prices quickly. For existing home owners, the decline in the value of their homes will be painful.

It seems the loan books of Bay-area regional banks are worthy of further inspection.

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