



Take the Test

UNDERVALUED SECTORS

(CONSIDER!)

- LARGE CAP VALUE
- DIVIDEND STOCKS
- CONSUMER DEFENSE

OVERVALUED SECTORS (AVOID!)

- SEMI-CONDUCTORS
- CALIFORNIA MUNICIPAL BONDS
- CHINA

As an employer, we know all too well that math and algebra skills are almost completely lacking in California high school graduates. Therefore, the outcry of well meaning, but wrong, educators and others regarding the California High School Exit Exam has us perplexed. Thousands of students have successfully graduated without knowing basic algebra because the state is granting waivers to just about anyone who asks. All of us should be very disappointed that we are short-changing students this way. To not challenge students is simply wrongheaded, as are the claims that these problems are too tough for California students. We are a great state in a great nation — our students should be more than capable of handling this subject.

You be the judge. Here are 3 questions from the test.

Question 1: $|Y+2| = 9$, Solve for Y

A. $\{-11, 7\}$ B. $\{-7, 7\}$ C. $\{-7, 11\}$ D. $\{-11, 11\}$

Question 2: In a certain room, the number of chairs, c, is equal to 3 times the number of tables, t.

Which equation matches the information? (x in this case represents the multiplication function.)

A. $3 \times c = t$ B. $3 \times t = c$ C. $3 \times c = 3 \times t$ D. $c \times t = 3$

Question 3: A shopkeeper has x kilograms of tea in stock. He sells 15 kilograms and then receives a new shipment weighing $2y$ kilograms.

Which expression represents the weight of the tea he now has?

A. $x - 15 - 2y$ B. $x + 15 + 2y$ C. $x + 15 - 2y$ D. $x - 15 + 2y$

Answers are on the last page of the Counselor...

Is There a Housing Bubble Out There?

After the Federal Reserve raised interest rates a quarter of a point at the end of June, newspapers the next day all blared messages similar to that of the July 2 Los Angeles Times; "Home Market Shows Hints of Cooling Off". The argument these pundits make is that home prices are in a bubble that will burst as rates increase and sellers add supply to the stock of homes available. Their logic is that this oversupply will eventually drive down prices, causing real-estate speculators to sell their investments under water, which in turn, will cause even more selling.

The question is then, are we in a housing bubble? and will it burst? The answer isn't that simple. It depends not only on where you live but a number of other factors. First, it is important to understand that home prices don't always respond in a logical fashion to the laws of supply and demand. In a normal economic world, the greater the demand for something, the more competitors who will enter the market to supply it. The high initial demand spurs higher prices, which increase the number of businesses trying to make the product, which eventually causes a glut on the market, causing prices to fall. It's basic supply and demand.

The same should hold true for housing. If there were high demand, you would think land developers would be building more homes. This does happen in many places, but not in all locales. Not surprisingly, the areas where normal supply-demand doesn't exist are the places with the highest prices, such as New York and the California coast. "They aren't making any more land," as the saying goes.

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However, land may not be the prime culprit. A study by the National Bureau of Economic Research shows housing price growth in Manhattan before 1975 was modest amidst abundant new construction. Since 1980 however, housing prices have soared with few new units added. By contrast, in the Las Vegas market, which was the nations fastest growing market in the 1990's, prices remain low because of the abundant land and the lack of stifling regulations. According to the study, because the development edge of cities involves endless conversion of farmland (desert) into homes, the costs of construction remain tied to the law of supply and demand. However, if the rise in housing prices during the 1990s was the result of demand pushing along a stable supply curve, then surely we would see an explosion in new construction as we did in the past. This simply hasn't been the case.

If the similarity in price growth within the United States was the result of different patterns of demand, then we would expect to see quantities and prices move together. Places with high price growth would be places with new construction. Instead, the areas with the highest prices have the least amount of new home construction, which is the opposite of what they taught us should happen in Economics 101. The places that are building have little housing price appreciation and the places that have housing price appreciation are not building.

So, what's the problem with areas which have so little new home construction? Is it lack of land or possibly (drum roll, please) government regulation? If local laws limit new construction, then higher prices result as an area grows. Even in areas where there is new construction, it might not be keeping up with demand. California grew by 600,000 people last year, and 500,000 per year for the last four years. 2,000,000 new people need around 800,000 new residences (homes and apartments) just to keep up with population growth. Part of this is the growth in immigration, particularly in California. When looking at the natural growth of minority households coupled with new immigration, the minority percentage of households has risen from 17% in 1980 to about 26% today and is expected to rise to 34% by 2020. Meanwhile, the minority share of renter households surged from 31 percent to 39 percent over the decade.

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Long-term, then, the total aggregate demand for housing -whether owned or rented - is going to rise. So, then can we conclude that housing prices are also going to rise as well solely because of a growing population? The short answer is not necessarily. We believe the key to assessing the strength of the housing market is affordability. The National Association of Realtor's defines affordability as when the median family income qualifies for an 80% mortgage on a median priced home. Currently we are near all-time highs in affordability.

The demand for housing is a function of income and wealth along with the negative effect of interest rates. The fly in this ointment, especially in California, is that high home prices reduce affordability. In 1950, the average cost per square foot was \$11. Today it is \$91. Much of that is inflation, as inflation alone would increase prices to \$76. The actual value of a square foot today is far more however. In the 50's homes typically did not have air-conditioning, had one bathroom, rudimentary appliances, heating was a space heater in the main room. Over the last ten years, the quality adjusted home price rose about 45%, while other home price measures increased by 64-69% according to Bear Stearns. This suggests that about "20% of home price appreciation might have been due to improvements". Over this same period disposable per-capita income rose 52.8%. Once again this shows that the median home price is not in a bubble.

We feel that the evidence is pretty clear that home prices are not in a bubble for most of the country and that over the long term, they should increase with the rate of inflation. In California and other heavily regulated areas, home prices may well be in a bubble phase due to a restraint in supply caused by regulation. These regulations serve to benefit existing homeowners because the scarce supply drives up the prices. As the high prices drive potential homeowners to other locations (ie. California to Las Vegas), demand will drop and prices can correct to a more predictable level...by the laws of supply and demand, of course.

Test Answers

Answers: Q1 A, Q2: B, Q3: D

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Continued Prosperity in 2004!**