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Remarks of

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The Real Estate Outlook for 1976

While it has become a ritual to utilize the early part of a new calendar year to make projections for the coming twelve months, most of you have probably already made your own plans for 1976. Successful participants in the real estate industry know of the need for advance planning to a greater degree than in some other sectors of our economy.

Nonetheless, I'd like to share with you my own assessment of some of the principal factors that will influence real estate in 1976. I am, of course, speaking only for myself not for my colleagues on the Federal Reserve Board.

It's important in any real estate outlook to realize there is no such thing as a national real estate market. It only exists as the sum of a large number of local markets. When you discuss real estate in general terms, it's also important to remember there are always good local markets in bad times, and bad local markets in generally good times. Therefore, your own real estate forecast must be carefully cut to suit your own individual market pattern. If you operate in one city, the forecast needs to be for that city. If you operate in Northern California, then you need the total of a series of local individual forecasts.

Given this assumption, you might logically ask why one who has recently moved to Washington from Alabama, would dare to talk about the outlook to a local group in Northern California. My reason is only to give some broad perspective of national events which will in turn be reflected in your local markets during the coming year. As one who has been an active practitioner in local real estate markets, I hope that my comments from this new perspective will be a benefit to you in making your own forecasts.

Let's focus first on some things which have a high probability of occurring in 1976. While nothing is absolutely certain, I personally feel that the probability of these things taking place is sufficiently strong that you should be prepared to expect them.

The cost of new construction, whether it be a house, a store, or an office building, will continue to go up Why do I think so?

We have learned that the high proportion of the construction labor force that is unemployed has only slowed -- it has not stopped -- the rapid rate of hourly wage increases in the construction industry. This fact, when combined with the rebound in the price of building materials from its 1975 low, convinces me that the labor and materials factor in new construction is going to increase again this year.

If -- as I personally think likely -- many of our cities will be unwilling to borrow for extension of their utility systems in 1976, this may encourage price stabilization of developed land. Even so, raw land not suitable for immediate development may recede from its speculative heights of recent years. I am not sure in my own mind whether the financial condition of many land developers will produce some fire sale liquidations which will depress prices of developed lots during the year. I personally hope not, since forced liquidation of real property on depressed markets only tends to depress prices further and hurts everyone in the long run.

These comments about raw land, of course, don't apply to agricultural land which is suitable for modern economical and mechanical farming techniques. This, I believe, is likely to continue to rise in value this year. However, historical perspective would lead you to question whether we may soon experience another decline in farm land value similar to those experienced after previous periods of sharp rises in agricultural prices, when land prices fell with farm product prices.

Everyone knows that unit sales of new single family houses have been down in 1973 and 1974. Yet the median sales price of a new home sold in 1973 was $32,500, up 18 percent; in 1974 the median price was $35,900, up 10 percent; and in October 1975 the median sales price was $40,700, up 9 percent from a year earlier. Put higher labor materials, land and expectations together and the result is bound to produce higher total construction costs this year.

The second strong probability, I believe, is a slow rate of apartment construction. Here are some reasons apartment construction is likely to continue in 1976 at about the present pace. Many communities still have abnormally high vacancy rates. For that reason, gross rental rates will have trouble rising enough to keep pace with galloping increases in operating costs for utilities, maintenance, taxes, and management. So net rents will go up little, if at all. These net rents, as all of you know, are the basis of new construction decisions when they are compared with the cost of construction, the cost of debt service, and the need for a reasonable return on equity.

The demand for apartments is influenced by the rate of household formation, which in recent years was increased by a growing number of single person households. However, the number of new households formed this year will, in my opinion, be depressed by a continued high rate of unemployment among young adults. This means that the apartment market will not grow for the singles only, "swingers" groups. It may well be possible that the number of young people reaching the marrying age will create growth in the market for units designed to appeal to young families.

But there are other negatives. One subtle but nonetheless important impact on multi-family construction is the change in the legal and social environment within which apartment investors now live. Many of our court jurisdictions have revised the fundamental legal rights of landlords and tenants so that the rights of the tenant, to a certain extent, take precedence over those of the landlord. Investors are becoming alarmed about the increasing number of communities going the myopic route of rent control, which they feel is another form of confiscation of private property. Also, many investors learned bitter lessons during 1974 and 1975 concerning the tax ramifications of loan default on accelerated depreciation schedules. Therefore, the tax shelter aspects of multi-family construction, while still important, are viewed with a great deal more care than before.

My last reason for caution about apartment construction is a short-term negative but long-term positive. I believe that the leadership of our Federal Housing programs now know that liberal credit or other subsidy programs to stimulate multi-family construction, which are not soundly based on market realities, create more problems than they solve. Therefore, moves by our Government in this direction will likely be gradual in implementation and modest in scope.

Now let's discuss some factors which, while less certain, are still highly probable in 1976. The most important of these is the fact that the tendency to inflation remains strong. It's not news to say that the pace of inflation, while down from 1974, has continued at a relatively high level despite unemployment and plant utilization figures which had led us to expect lower prices. I am increasingly impressed that the causes of this situation appear to be coming from structural, endemic conditions in our economy which are not likely to be resolved very quickly.

While it's my belief and hope that inflation will moderate further in 1976, investors are still unlikely to commit long-term loans at cheap interest rates without more assurance that inflation is being contained.

I think it is highly probable that 1976 will see only a modest demand for more stores, shopping centers, and office buildings. Retail sales while up in dollar amounts are not rising rapidly when measured in terms of the quantity of items sold. This fact coupled with the slower changes in transportation and living patterns will also slow the need for new shopping facilities unless someone is soon able to invent a new merchandising concept to replace the discount store, the super market, and the shopping center.

While general business conditions are improving, our corporations have learned in 1975 to operate on lower overhead and with better efficiency. Therefore, the overhang in the supply of office space which some areas are experiencing will be gradually filled from older non-economic buildings and from only modest overall market growth. This is a condition tending to keep office rents depressed and the demand for new office building construction sluggish.

For some people, perhaps the most discouraging probability during this year is the prospect for resort and recreational properties. I think that the speculative fires of 1973 and 1974 burned enough fingers that it will take some more years to rebuild public confidence in this type of property. I also think that a large part of this market is usually motivated by a feeling of financial well-being on the part of our families who are relatively well off. In that context, while corporate profits have rebounded sharply from the 1975 lows, thus far the stock market shows no inclination to rise to a point that shareholders might be encouraged to spend some paper profits on a secondary home.

Thus far, unfortunately, "calling it like I see it" has produced a very discouraging outlook. You may properly ask, "is there anything good about real estate for 1976?" In my view, yes, there is. The bright star for 1975 will continue to shine in 1976. Namely, the single family home market. Why?

As I have already noted, the fundamental demographics are still positive. The number of our young people reaching the age where they are expected to marry and buy houses is growing. While there has been much conversation about changed living patterns and even changed marital patterns in recent years, the figures would lead us to believe that these people will buy their share of houses when they get to the house-buying age, just like your and my generation did. Furthermore, it looks like our consumer incomes are continuing to increase in real, as well as in nominal terms.

The fundamental conditions are also positive for an ample supply of the mortgage money which usually sustains single family home purchases. The growth of savings in 1975 has produced a highly liquid thrift industry. About 10 percent of its assets are now in liquid form, while the level of forward commitments is modest in proportion to internally-generated cash flow. These facts should help insulate thrift institutions against a sudden change in the inflow of new deposits, should that occur in the months ahead.

Most economic projections do not call for a rapid growth in economic activity in 1976. This suggests that credit demands will not likely push interest rates up sharply.

Two factors, though, deserve a further note of caution. The first is that urban single family mortgage credit is now almost totally dependent on the thrift institutions and the Federal Government for funds. While commercial banks still make about 14 percent of these loans, not a single other source of savings capital has significant interest in home loans today. For this reason, any change in the prospects for thrift institutions would be likely to produce sharp changes in the mortgage market.

The second factor worth watching is the continuing level of Federal deficits needing to be financed. If gross credit demands should expand in 1976, it could well be possible that Treasury borrowing could put upward pressure on short-term interest rates.

The best news for 1976, in my opinion, is a fundamental change in market psychology for single family homes. We learned in 1975 that the general public would buy existing houses in record numbers at today's prices. We also learned that the public will pay 9 percent interest for mortgage money without the mental blocks that drove many from the market earlier. I feel that this change has taken place because the American public has increasingly learned that a home is a good buy at today's prices and interest rates. They have learned about the prospects in most areas for increasing market values. They have also learned that the amenity benefits which they are receiving through home ownership are needed by their families now, rather than later after the children are grown and gone.

This renewed emphasis on single family homes is good news in several non-real estate ways. It's good news economically because it encourages a multiplier effect on spending and production. It's good news socially because it strengthens our family ties and produces a more stable society. It makes more families have a stake in the future of our cities, and, therefore, in our nation.

Perhaps the most certain thing to happen in 1976 is that it will produce surprises. The biggest of these is likely to be the opportunities which have existed, but you and I have perceived too late to utilize.

I've been impressed for years by a trite phrase. "Opportunity is where you find it." Notice very carefully what this phrase says but doesn't say. It does not say "where opportunity finds you." But rather "where you find it."

So 1976, like 1975, and like 1977, will end up being the kind of year you and I determine to make it at the beginning.