A Caution On Owners' Equivalent Rent

Can The Performance Of Three Stocks Make A Macro Indicator?

I noted in July 2011's Housing Market: The Shift to Tenancy Continues how new housing construction was shifting gradually toward more multi-family units and away from the classic single-family detached home. Not that the U.S. is getting carried away with this trend; the percentage of multi-family starts was much higher during the early 1960s and again during the early 1970s when both demographics and economics were considerably different.

In addition, I have been using an indicator based on the return differential between apartment REITs and all REITs to assess where owners' equivalent rent (OER) is headed. If you want to get the moon-howlers going, OER is a good place to start; only the monthly employment report's birth/death estimate of new businesses seems to get the juices going similarly. The reason is simple: OER is the implied price at which a home could be rented each month, and as the Bureau of Labor Statistics notes:

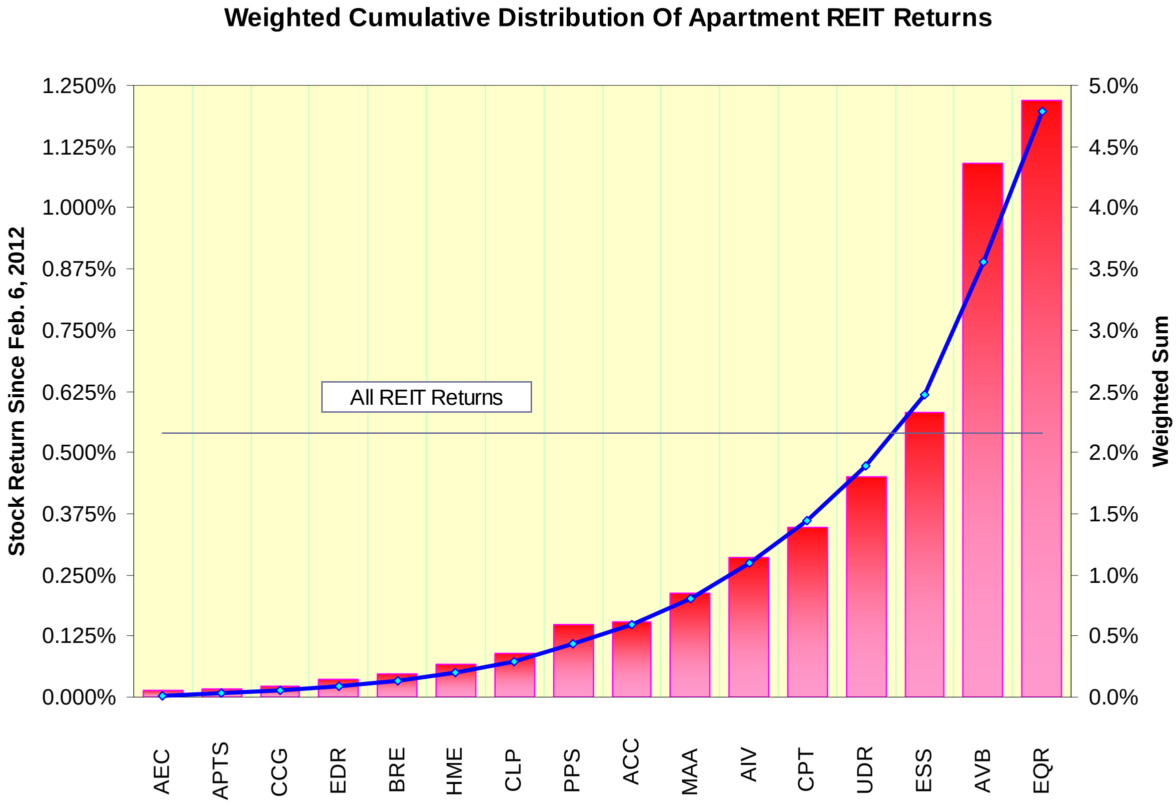
Clearly, the rental value of owned homes is not an easily determined dollar amount, and Housing survey analysts must spend considerable time and effort in estimating this value.

As an aside, if you think OER is impossible to derive and even if you accept all efforts to calculate it are made in good faith the BLS tells you to take it with a grain of salt, just wait until someone pushes the doctrine of "comparable worth" forth in labor markets. Soviet-style central planning failed wherever it was tried for good reason.

The Apartment REIT Indicator

The return differential between all REITs and apartment REITs has been expanding very rapidly since early February; apartment REITs have returned 4.78% versus 2.16% for all REITs. By itself this is signaling an increase in OER going forward for at least three months. As OER constitutes 25.593% of the CPI, this indication by itself should set off alarm bells for those fearful of rising inflation readings.

However, before you go ride off to spread the alarm to every Middlesex village and farm or whatever it is you do in these situations, take a look at the composition of those gaudy apartment REIT returns. The excess returns derive from just three issues, Essex Property Trust (ESS), AvalonBay Communities (AVB) and Equity Residential (EQR). Even if you think these stocks can keep powering ahead of other REITS, caution is indicated if for no other reason than relative performance is highly sensitive to the starting date chosen. If we used year-to-date returns, apartment REITs would be lagging the entirety of REITs in return, 9.68% to 11.25%. Would that mean we could blow the all-clear siren on rising OER and by extension on consumer prices? Hardly.



I prefer to use market-derived measures wherever and whenever possible as they eliminate quibbling over calculation methodologies and should shove conspiracy theories aside (an exception is made here for gold prices; here the lunatic fringe avers market prices are manipulated down by some official secret-handshake crowd). However, when a market measure is so sensitive to the performance of just a few stocks and to the start-date chosen, I have to take a page out of the BLS Website and prescribe a grain of salt.