In June 2002, I issued a definition of a regional housing bubble: home price to rent ratios that elevate without support from the underlying fundamental: the rental value. Just as in stocks, a high price to rent ratio is justified in regions where rents can be expected to increase substantially in the future. But be very wary of regional markets with elevated price to rent ratios but weak future economic prospects. That, I argued, was the San Francisco Bay Area, which as of a year ago had a weak rental market currently and prospects for weak rental market for some time to come, but a strong asset market (strong home prices). That's a bubble.

Now a year later, it's time to take another look.
Median Home Prices in San Francisco remain elevated

**Median Home Prices**

San Francisco vs. LA

**San Francisco Premium**

Median Price of SF / Median Price of LA Homes Sold
But the Bay Area rental market is soft.
And Bay Area P/Es remains elevated, though LA is catching up

**Price/Earnings Indexes for California homes**

**Median Sales Price / Shelter CPI index**


0.6 0.7 0.8 0.9 1.0 1.1 1.2

Interpretation:

The price premium for the median priced home in San Francisco increased from 20% at the start of the 1990s to over 100% in the year 1999. That appreciation of SF prices compared with LA prices was supported by the fundamental of a relatively strong rental market since rental rates in San Francisco increased by 25% over LA rents. But since the dot-com collapse, rents in San Francisco have stabilized while rents in LA continue to increase.

The bottom line is that SF has an elevate P/E ratio but a week E market now, and for some time to come. That’s a bubble. But keep in mind a housing bubble doesn’t burst but only slowly deflates. Expect a long agonizing decline in prices like we had in LA in the early 1990s.
Price/Earnings Ratios Elevate in Markets with Strong Appreciation of Rents

But don’t count on getting support for that elevated P/E in the next decade

A Strong Rental Market One Decade Doesn’t Mean Much For the Next

Interpretation:

There is an overshooting problem with asset prices amplifying swings in rental values, which swings are not sustainable because of the regional competition for business.