

## Real Estate Rents and Prices

*by Luke T Miller PhD*

Real estate is a major economic driver in Durango and the surrounding region. Since 2000 many have seen their homes double in value, with homes appreciating nearly 12% per year between 2000 and 2007. However, let's put things in historical perspective. Between 1980 and 1999 home prices in Durango appreciated about 5% per year, with homes appreciating 5.3% per year in the 1980s and 5.4% per year in the 1990s. At these growth rates a home would double in value every 12 to 13 years. Since homes have already doubled in value over the last seven years, it is quite plausible that home appreciation will remain unchanged over the next 5 years to balance out the great start in the 2000s. In fact, utilizing a research method employed by some of the nations top economists point to a similar conclusion.

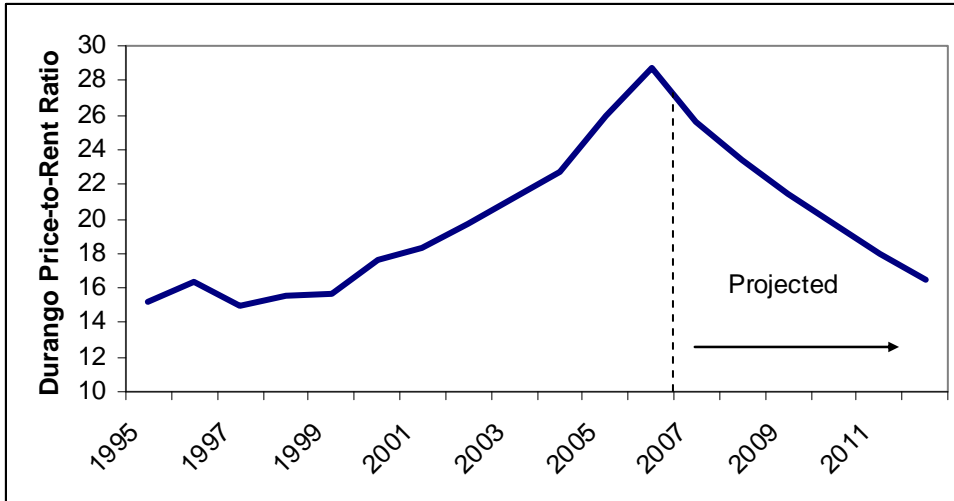
Many factors determine the value of a house to include location, home size, neighborhoods, school quality, interest rates, employment, and population growth. But over time the most reliable guide to home values has been the relationship between median home price and annual rents, or the Price-to-Rent ratio (P/R ratio). This is very similar to the stock market's Price-to-Earnings ratio (P/E ratio) indicating the price investors are willing to pay for a company's level of earnings. Historically in the US, the P/R ratio has been around 14. That is a P/R ratio for the nation has averaged 14, sometimes straying from it higher or lower, but always and inevitably pulled back to 14. Economists call this a mean reverting process.

During the 1980s and 1990s in the US, the P/R ratio hovered near 14, spiking to 24 between 2000 and 2007. What happened? The rental growth rate actually slowed during this time period, and the price of homes across the nation nearly doubled. For example, consider Durango data for 1995. Annual rents in Durango were \$9,510 and the median home price was \$145,000. Divide \$145,000 by \$9,520 and you get a P/R ratio of 15.2. In 2006, the average annual rents were \$14,750 and the median home price was \$423,000, or a P/R ratio equal to 28.7.

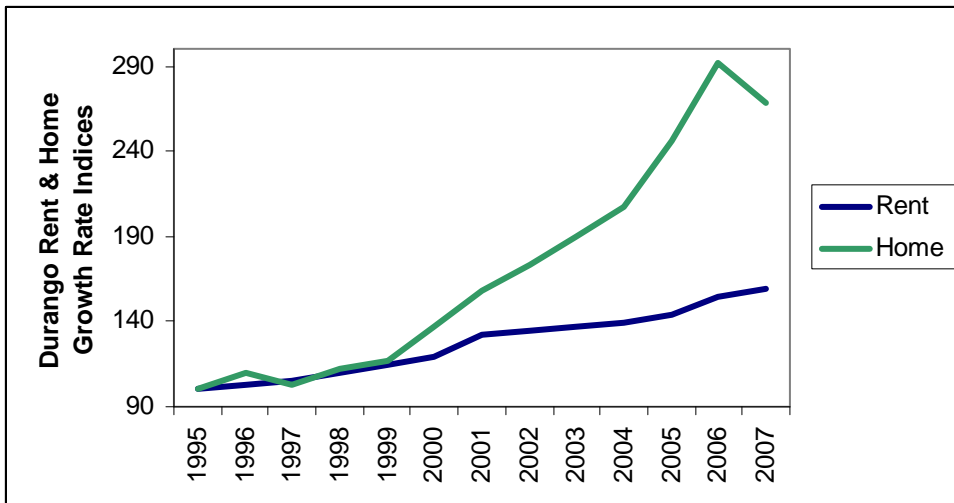
One of two things must happen for the P/R ratio to mean revert to Durango's historical multiple of 16: (1) increasing rents and/or (2) unchanged to decreasing home prices. Additionally, consider that both rents and weekly wage rates increased 4% on average during the 1980s and 1990s in Durango. In other words, rents increased at a rate comparable to weekly wages. Since 2000, rents increased about 2% per year, while weekly wage rates increased about 6% per year. Objectively speaking, rents will probably play catch up with wages. If rents increase 7% per year for the next 5 years and home values correct an additional 10%, then the P/R ratio would mean revert to 16.

Following the P/R ratio theory in Durango, five years from now rents could be 40% higher and home prices could be 10% lower than today. These results are on par with national projections determined by leading researchers – namely, five years from now home prices across the nation could be 16% lower versus where they are today, with some hot markets like Florida and California projected to correct an additional 30%.

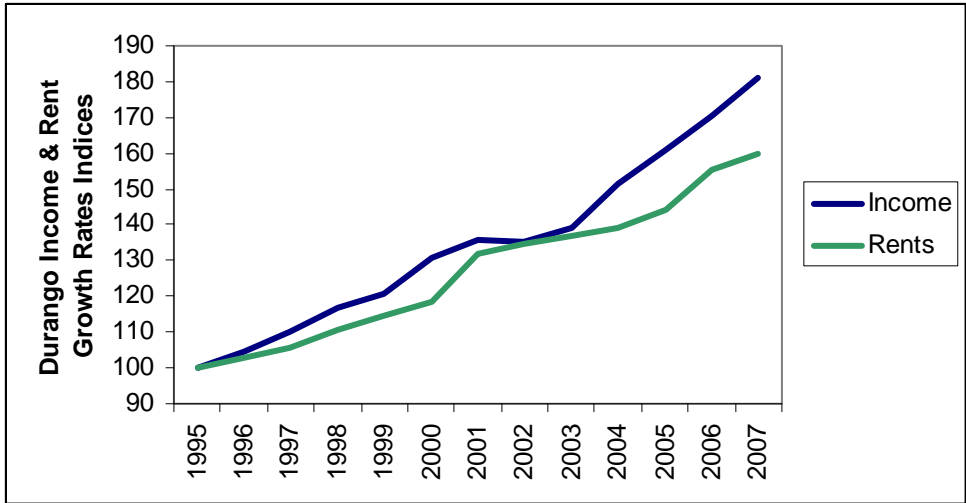
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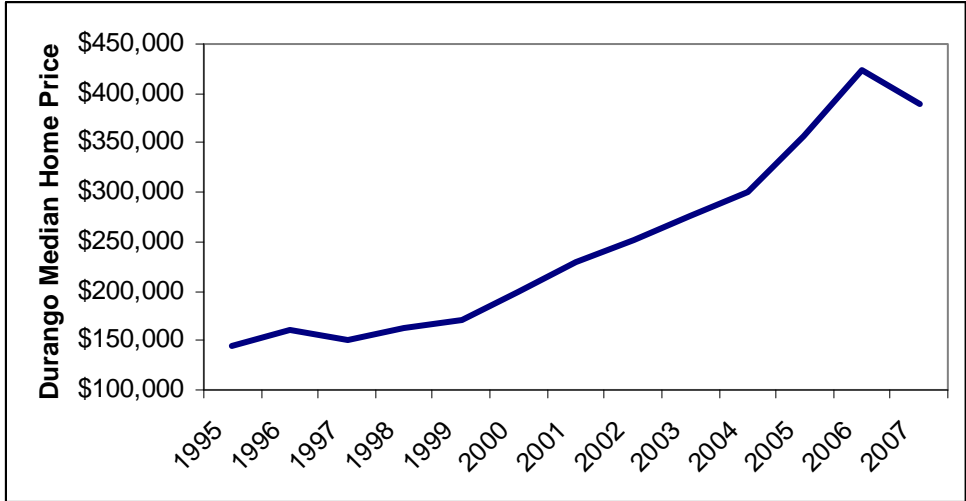
**Figure 1:** A plot of Durango’s Price-to-Rent ratio since 1995. Notice the spike in the P/R ratio beginning in 2007. The projected return to Durango’s historical P/R ratio assumes a 7% annual growth in rents and a -2% annual growth in home prices.



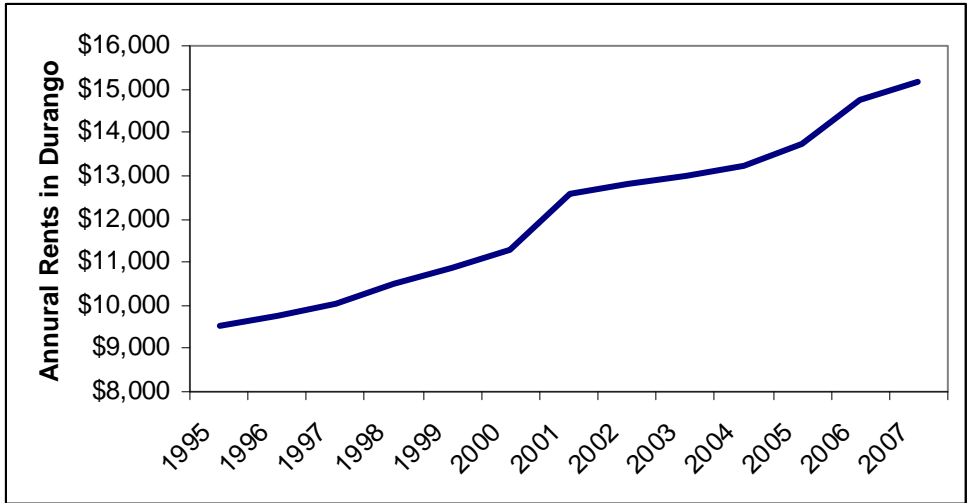
**Figure 2:** This plot compares the rent and home growth rates since 1995. Notice that the indices tracked one another fairly well until 1999. Then from 2000 to 2007 home appreciation far exceeded rental growth rates. In order to return to historical Price-to-Rent norms, rents will probably increase and home values decrease.



**Figure 3:** Shows the growth in rents versus income levels in Durango. Notice how income levels accelerated quicker versus rents beginning in 2003.



**Figure 4:** A plot of Durango home prices since 1995.



**Figure 5:** A plot of Durango annual rents since 1995.