Dwayne M. Dills, CPA, PC
Financial Advisor and Certified Public Accountant
18-D Regent Park Blvd. • Asheville, NC 28806
Phone: 828-398-0258 • Fax: 828-225-3900

Securities offered through Southeast Investments, NC, Inc., Member FINRA, SIPC
OSJ: 820 Tyvola Road, Suite 104, Charlotte, NC 28217 Phone 704-527-7873

Financial Briefs

JANUARY/FEBRUARY 2014

Are We Facing Another Housing Market Bubble?

It would be ideal, of course, if we could predict real estate bubbles. Then we could make policies that might stymie their growth or at least avoid buying at high prices. Unfortunately, we can't, but we can think about the signs that might point to a housing market bubble and educate ourselves on what to watch out for.

4 Factors to Consider

1. Overbuilding. For many homeowners, the images from the height of the last housing market bubble are seared into memory: Single homes languishing in neighborhoods built for hundreds. Whole communities with roads and streetlights but no homes. Overbuilding was clearly a problem in the last real estate bubble.

Seven years later, builders are finally building again. Are they overbuilding? By most indications, no. "Builders need to produce 1.5 million new homes to keep up with growth — but they've been building only about 500,000 new homes each year for the past six years." (Source: *Are We in Another Housing Bubble?*, March 28, 2013) So in fact, builders may be underbuilding, though that can change very quickly.

2. Low interest rates. The debate over whether historically low interest rates in the aftermath of the 2001 recession caused our last real estate bubble remains unsettled, but it's generally true that low interest rates drive up demand for mortgages which, all else equal, drives up the price of homes. Today, interest rates remain near historic lows, but the Fed has said that as long as the economy continues to improve, it will begin to rollback the stimulus that is keeping interest rates so low. Rising rates, then, are likely to put a damper on demand for mortgages, thereby slowing home price increases.

3. Shadow inventory. There has

Continued on page 2

Does Homeownership Still Make Sense?

There's no denying that for most of us, owning a home feels good. But does it make sense financially? Here we'll consider some reasons why it may and some reasons why it may not.

Owning a Home Can Make Good Financial Sense

1. The total cost of homeownership — including tax breaks — can be less than renting. The government has long believed that homeownership is good for Americans and for America and has, therefore, supported homeownership in a variety of ways. One of those ways is giving substantial tax breaks to homeowners. One of the most significant of those is the mortgage interest deduction, which allows homeowners to deduct mortgage interest on a first and second home, up to a certain maximum. When you sell the home, a significant amount of capital gains can be excluded from tax. If the home was your primary residence in at least two of the preceding five years, you can exclude $250,000 of gain if you are a single taxpayer, and $500,000 of gain if you are married filing a joint return. Mortgage points, private mortgage insurance, and property taxes are other tax breaks available to homeowners.

2. At the end of the mortgage term, you'll have a rent-free place to live and 100% equity in the asset. Once you've finished paying off your mortgage, you'll have a rent-free home in which to live. You'll also have 100% equity in the asset that is your home — meaning you can sell it, leave it to your heirs, or even take equity out of the home with a reverse mortgage. For many people, the ability to have a home to live in rent free and an asset of substantial worth is an important part

Continued on page 3

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FR2013-0812-0098

Are We Facing?

Continued from page 1

been much debate lately about whether a shadow inventory — homes that are not occupied but not on the market for sale — actually exists. Recently, former FDIC Chair Sheila Bair said lenders may be sitting on huge numbers of foreclosed houses that have been held back from the market. "As housing prices start to perk up, that hidden inventory may come flooding into the market — and push prices back down."

4. Price changes. Price changes are the trickiest, most potentially confusing, factor to consider when deciding whether we're headed for a housing bubble. Because on the surface, rapid recent price increases scream, "Yes, we're in a bubble!" According to national home price data from Case-Shiller, average home prices were up more than 10% in March 2013 over the previous year. That's more than double the normal average price increase of 3–5%. But it's important to take into account the fact that we're recovering from the worst housing crash since the Great Depression, and housing prices are still 28% below their June 2006 peak. (Source: S&P/Case-Shiller U.S. National Home Price Index, 2013)

Bubble? No Bubble? What Can You Do?

Anyone who bought a home in the last eight years likely feels burned by the last housing bubble. Millions of homeowners bought high, only to see the value of their homes decline substantially and found themselves with a mortgage value higher than the home's worth. No one wants to go through that again.

If you're thinking about buying, there's no way to be certain if the price you decide to pay is an all-time high price or a fair market value. But here are some steps you can take to protect yourself:

- **Take your time.** No matter what anyone says, don't be rushed into making a home-buying decision.
- **Do your research.** Analyze price trends in the area you're considering. How do today's prices compare to trend? Then look at prices of homes in one area and compare them to prices of similar homes in another area. Are price differences justified (e.g., by better schools, more central location, etc.)?
- **Seek the help of a trusted, professional real estate advisor.** Find a real estate advisor who you trust is looking out for your interests, not just looking to make a sale. Asking friends and family for a referral is a good way to find that person.
- **Buy for the long haul.** The fact is that even homeowners who bought at the height of the last real estate bubble will probably be fine as long as they planned to live in the home for a while. Buying a home makes the most sense when you plan to be in it for the long haul.

Please call if you'd like to discuss this in more detail.

Buying a Second Home?

For many Americans, owning a vacation home is a long-held dream. If it's one of your dreams, consider these five factors before you decide to purchase.

1. Where will the mortgage money come from? Your first financial priority, after meeting your living expenses, should be to build up a rainy day savings of 3–6 months of living expenses and then to fully fund your retirement accounts. If you've met those goals, weigh your desire for a second home against the other things you'd like to spend money on.

2. What is the true, total cost of second home ownership? The costs associated with owning a home go far beyond just the mortgage principal and interest payment. You'll also have to consider: mortgage closing costs, state and local property taxes, homeowners insurance, private mortgage insurance, homeowners association dues, maintenance, utilities, home security, and furnishings. At the same time, there can be substantial financial benefits to owning a second home, including tax deductions for mortgage interest, property tax, and other homeownership-related expenses.

3. How does the cost of owning a vacation home compare to the cost of renting a vacation property? Many people who own a second home buy one in a place that they visit frequently. It's important to consider how often you would actually use the vacation home. For many people, the total cost of owning a second home is much more than renting a home or staying in a hotel every visit.

4. Will you use the second home as a source of income? Since 1987, the average annual home price increase was 2.8%, just a hair above inflation. So as a pure investment, a second home probably doesn't make sense. However, if you intend to stay in the home when you vacation or rent it out as a source of income, it can make sense to buy.

If you plan to use your second home as a source of income by renting it out, the tax implications may be different than if the home is just a vacation home. Explore those implications with your tax advisor. Also, it's important to research the rental market in the area you're considering.

5. What are prices like in the market(s) you're considering? Trying to assess whether a home is undervalued or overvalued is difficult. But by researching price trends in the market(s) you're considering, you can get a sense of whether homes are under or over price trends. If they're over, now might not be the best time to buy; if prices are below trend, you might be able to get a good deal.

Please call if you'd like to discuss this topic in more detail.

Does Homeownership?

Continued from page 1

of their retirement plan.

3. If you lock in a mortgage rate for the term of your loan, the majority of your homeownership costs will be predictable. While you can't predict how property taxes or other expenses might change, a major portion of your total cost of homeownership is your mortgage payment. So when you take out a long-term, fixed-rate mortgage, you know with certainty how much your mortgage payment will be each month, no matter what happens in the market with interest rates, inflation, or investment returns.

On the Other Hand, Homeownership Might *Not* Make Financial Sense

1. When accounting for inflation, homeownership may not be a great investment. Robert Shiller, a Yale University economist and cocreator of the S&P/Case-Shiller Home Price Index, has warned against viewing homes as an investment. "Because people often forget to correct for inflation, they may have the illusion that the market is improving." (Source: *The New York Times*, April 13, 2013) Between 1987 and 2012, for example, the average annual increase in U.S. home prices was just 2.8% — barely over the average annual rate of inflation for the same period.

2. It's typically more difficult for homeowners to relocate for work than renters. It intuitively makes sense that when you own a home, the only way you can move far away (unless you're able to own two homes) is to sell the home you're in. That concept is borne out in research as well: high rates of homeownership are aligned with lower labor mobility and longer commutes, according to research published in May 2013 by the Peterson Institute for International Economics.

3. The total cost of homeownership can be more than renting. Sometimes, the total cost of homeownership is less than the total cost of renting. But sometimes, owning a home is more expensive. One way to figure out if owning or renting is more expensive in your area is to calculate the price-to-rent (P/R) ratio:

- Find two homes — similar in location, size, and amenities — one for sale and one for rent.
- Divide the sale price of the home for sale by the annual rent of the other.

The economists' rule of thumb is that when the price-to-rent ratio is higher than 20, the monthly costs of ownership will exceed the cost of renting. Generally, the higher the P/R ratio, the less sense it makes to buy.

The decision to own a home — or not — is one that has to be made based on your own individual circumstances.

8 Tax Breaks for Homeowners

Homeownership isn't cheap, but it does come with certain perks. Some of those perks include tax breaks. Below is a list of some of the key tax breaks you may qualify for as a homeowner.

1. Mortgage interest deduction. The mortgage interest deduction allows you to deduct mortgage interest you pay on a first and second home, up to a maximum of $1 million in mortgage debt (for single filers, the maximum is $500,000). But, you can only deduct interest on mortgages for two homes.

2. Home-equity loan interest. If you take out a home-equity loan, the interest you pay is deductible, with certain restrictions. If you use the loan to improve your home, the interest you pay on the debt is fully deductible (subject to the $1 million cap). But if you use the loan for a reason other than to buy, build, or improve your home, you can only deduct interest paid on the first $100,000 of debt.

3. Sale of home. When selling a home, you can exclude gains of up to $250,000 if you are a single taxpayer and $500,000 if you are married filing jointly, provided the home was your primary residence in at least two of the preceding five years. The exclusion can be used once every two years.

4. Points. Points are also tax deductible. Sometimes, buyers will pay extra points to secure a lower interest rate from their lender. One point typically is equivalent to 1% of the total amount of your mortgage loan.

5. Private mortgage insurance deduction. If you purchase a home but don't make a down payment of at least 20%, you will need to buy private mortgage insurance (PMI). PMI payments are deductible if you obtained the mortgage or refinanced on or after January 1, 2007. The PMI deduction begins to phase out for those at higher income levels but is currently scheduled to expire after 2013.

6. Property taxes. Sometimes referred to as real estate taxes, you can deduct any property taxes you pay from your federal taxes.

7. Home office deduction. If you work from home, you may be able to deduct the expenses you incur for the business use of your home. There are a number of caveats, however. You must use part of your home exclusively for business. You must also regularly conduct a substantial portion of your business in the space. Beginning in 2013, taxpayers can choose a simplified option for claiming the deduction, which allows them to deduct $5 for each square foot of their home used for business.

8. Tax credit for energy-efficient home improvements. In 2013, homeowners may be eligible for a credit worth 10% of the purchase price of certain qualified energy-efficient products, including insulation, windows, furnaces, and water heaters. You can claim a credit of up to $500. If you install a wind turbine, solar power system, or geothermal heat pump, you may be able to claim a credit of 30% of the cost of the item with no upper limit on the credit you can claim.

Business Data

Indicator	Oct-13	Nov-13	Dec-13	Dec-12	Dec-11
	Month-end				
Prime rate	3.25	3.25	3.25	3.25	3.25
3-month T-bill yield	0.05	0.08	0.07	0.09	0.03
10-year T-note yield	2.66	2.74	2.89	1.80	1.95
20-year T-bond yield	3.41	3.54	3.61	2.56	2.63
Dow Jones Corp.	2.98	2.99	3.11	2.70	3.74
GDP (adj. annual rate)#	+1.10	+2.50	+4.10	+0.40	+3.00

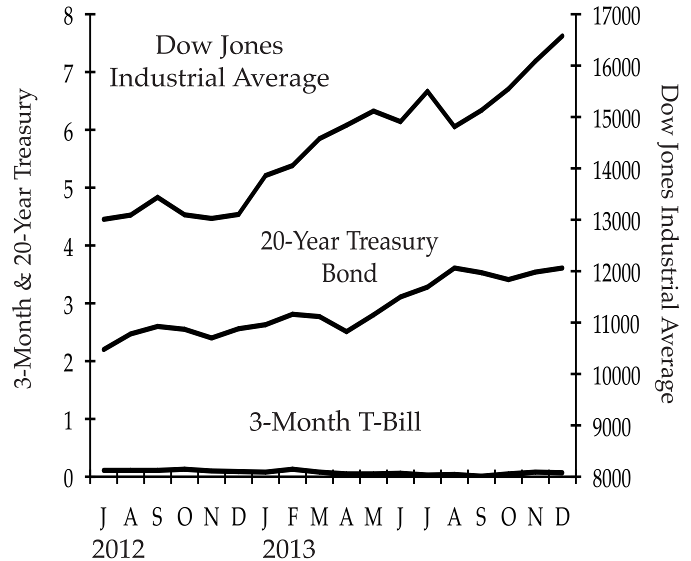
Indicator	Month-end			% Change	
	Oct-13	Nov-13	Dec-13	2013	2012
Dow Jones Industrials	15545.75	16086.41	16576.66	26.5%	7.3%
Standard & Poor's 500	1756.54	1805.81	1848.36	29.6%	13.4%
Nasdaq Composite	3919.71	4059.89	4176.59	38.3%	15.9%
Gold	1324.00	1245.00	1201.50	-27.7%	5.9%
Unemployment rate@	7.20	7.30	7.00	-10.3%	-10.3%
Consumer price index@	234.10	233.50	233.10	1.3%	1.8%
Index of leading ind.@	97.30	97.50	98.30	5.2%	-20.4%

— 1st, 2nd, 3rd quarter @ — Sep, Oct, Nov Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

July 2012 to December 2013



News and Announcements

Deciding on a Mortgage Term

When considering mortgage options, most homeowners debate whether to obtain a 15-year or 30-year mortgage. However, lenders offer other terms, such as 10, 20, 25, or even 40 years. Even after obtaining a mortgage, you can typically lower the term by paying additional principal with your mortgage payment. So how do you go about deciding which is the best term for you?

There are three basic factors you should consider:

- Since each term will have a different interest rate, you should review the rates for different mortgage terms. In general, shorter mortgage terms will have lower interest rates.
- Also consider the monthly mortgage payment, which will depend on your down payment, mortgage term, and interest rate. Longer mortgage terms have lower mortgage payments. Keep in mind, however, that your equity will build slower with longer-term mortgages. Monthly payments for 15-year loans are typically 15% to 25% higher than 30-year loans, but your interest costs are typically half, since your interest rate is lower and the mortgage is paid off much sooner.
- Your final consideration should be your financial plans. You want to select a mortgage term with a comfortable mortgage payment that will ensure you have money left over to save for other financial goals.

One option that gives you flexibility is to select a longer mortgage term, such as 30 years, and send additional principal in with your regular mortgage payment when you have the funds. Doing so can significantly decrease the term and amount of interest paid. However, you aren't committed to making the additional payments, which gives you financial flexibility.

Please call if you'd like to discuss your options in more detail.

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