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Is real estate finally a worthwhile investment?

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Is real estate a good investment right now? Of course that is a question that will surely get many opposing responses.

After all, the national housing market still looks pretty bleak: There were a record one million foreclosures last year. Home prices are still falling in many regions of the country and the number of "underwater" properties is at a record high. On top of this bad news, things do not look much better in other areas of real estate either. The number of construction jobs continues to decline, even as other parts of the economy have added jobs. Housing starts declined 4.3 percent in the final month of 2010. Mortgage rates have moved higher as long-term Treasury yields have backed up during the past few months.

Even though there are some niche opportunities for the savvy investor, for the most part, the real estate market remains a mess and most investors remain on the sidelines.

Real estate encompasses a wide range of property types — homes, apartments, hospitals, office buildings, strip malls, dormitories and other properties. But for purposes of this article, the focus is on residential real estate, or homes. There are some good reasons to think residential real estate might represent a bargain — with one big caveat — "homes" are probably the most hated asset class in the country. That is what happens when an economic bubble bursts. People avoid thinking about the value of their home. Sellers moan about no offers, buyers gripe about impossible lending requirements, everyone gets frustrated.

In investing, that creates an opportunity.

Hatred of an asset class is often the precursor to contrarian interest, and being contrarian is at the heart of many investment strategies. To paraphrase Warren Buffett, "be fearful when others are greedy and greedy when others are fearful."

Mr. Buffett backed that idea when he invested in the stock market in the teeth of the financial crisis in late 2008 and early 2009.

However, being contrarian is not necessarily a wise investment strategy. Gold was hated for many years and only more recently became an attractive asset class. Still, a lot of smart ideas begin with the question: "What does everyone hate?" So, smart people are buying real estate. This cohort is led by John Paulson, the hedge-fund manager who made $5.3 billion (NY Times) betting against the housing bubble. Last fall he said in a speech: "If you don't own a home buy one. If you own one home, buy another one, and if you own two homes buy a third and lend your relatives the money to buy a home." Why is Mr. Paulson so adamant? Because he believes long-term interest rates are not going to get much lower. They have, in fact, risen since he gave that speech, but they remain remarkably low by historic standards. Low rates and the expectation that home prices will rise is his argument. For his part, Mr. Buffett has predicted the housing market will bottom this year.

Historically, real estate has performed well during inflation. There is not much inflation these days; however, when buying a home one should take a longer view. And the longer view shows that the economy has enjoyed a disinflationary period since the early 1980s. A number of folks think that cycle is slowly reversing itself. If that is the case, then convention would argue for holding assets that do well in an inflationary environment. That includes Treasury Inflation Protected Securities, commodities and real estate. Remember that during the stagflation nightmare of the 1970s, real estate had a strong run.

Inflation is not currently a significant issue in the U.S., but it is a growing problem elsewhere. China and India have taken steps to fight inflation, the Euro zone is getting flickers of inflation and the U.K. has had oddly higher prices (above 3 percent) for an extended period of time. If the current cycle is slowly turning, real estate investment makes more sense.

The demand for housing may be coming back. Supply is not as out of whack as it used to be. At the end of November, home builders reported 197,000 new homes on the market, the lowest level since 1968, according to researchers. The National Association of Realtors reports that the inventory of existing homes for sale fell 4 percent to 3.71 million homes, which represents a 9.5-month supply at the current sales pace, down from a 10.5-month supply in October. Those numbers are still not pretty, of course, but they are moving in the correct direction. And that may be a reason that many home builder stocks, such as KB Home (NYSE: KBH - News), Hovnanian (NYSE: HOV - News), Pulte (NYSE: PHA - News) and Toll Brothers (NYSE: TOL - News), have come off their lows in the past several weeks.

It all comes down to jobs. There are a number caveats to any positive home thesis, but the big one is unemployment. If the economy is not creating jobs, the chance of a rebound in housing is diminished. It is hard to buy a home without a job, and folks who are not working do not want to take long-term risks. As the unemployment figures go down, consumer sentiment will strengthen. It is simply a matter of when this will happen and how it impacts the timing of a housing market rebound. For now, the job market is still struggling and the debate is hot about when it will recover. Optimists see recovery this year. Pessimists see pain for several more years to come. How an individual investor sees this X factor getting resolved will determine his/her strategy and whether or not it is time to consider real estate as a good investment.

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