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ECONOMIC NEWS UPDATE

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It is finally happening -- the much-predicted bursting of the bubble. Surprise: It is the gasoline price bubble that has burst, not the house price bubble. Prices of regular unleaded last week averaged about \$2.34 per gallon, below the levels prevailing immediately before Katrina struck, and well below the \$3.04 peak reached in early September. Crude prices also headed down from the \$70 per barrel level to \$57, a six-month low.

That did not stop indignant Senators from hauling the CEOs of the major oil companies to public hearings, at which they were excoriated for "price gouging" and for failing to reinvest their record earnings in new production and refining capacity. No matter that among the principle constraints on such investment are the laws these same legislators have passed, limiting drilling offshore and on federal lands, and turning the process for permitting new refineries into a bureaucratic nightmare. The industry's leaders pointed out that it takes twice as long -- eight years as compared with four -- to get a refinery

built in the United States as it does in China and other countries.

The temporary spurt in gasoline prices may be past, but its consequences linger. To the undoubted glee of America's critics, who argue that our gas-guzzling vehicles contribute to global warming, sales of full-sized pickup trucks have plummeted, dropping 26.4% in September and 31.8% in October, compared with those months last year. Worse still for automakers, sales of highly profitable sports utility vehicles (SUVs) have declined even more.

It will be some time before we know whether the fall-off in sales of these large vehicles is part of a permanent reaction to the higher petrol prices that followed Katrina, or to the decision of automakers to reduce the massive discounts that have brought buyers trooping into showrooms. General Motors, which some analysts now give only a 50:50 chance of avoiding bankruptcy, has cut its average discount by almost \$1,000 per vehicle, and is hoping that the robust job market

will result in a company-saving sales rise at profitable prices.

That will depend very much on what happens in the housing market. Last year, Americans “cashed out” some \$600 billion of equity from their homes, funding almost 8% of their spending at the malls, shops, spas and on vacations. If house prices decline, or even stop increasing, such equity withdrawals could fall sharply, and with them consumer spending. Worse still, if the housing market slows, the jobs market is likely to weaken. Xiuyue Zhu, a researcher-colleague at the Hudson Institute, estimates that almost five million workers are involved in the building, financing and other aspects of the housing industry. That’s one out of every 28 jobs in America.

That’s why there were shudders among economy-watchers when Toll Brothers, a leading builder, reported that contracts for the purchase of its new homes (average price \$679,000) failed to increase in its most recent quarter. As with sales of pick-up trucks and SUVs, it is difficult to tell whether this is a temporary blip in response to the pressure high petrol prices put on family budgets, or a permanent reaction to higher interest rates and what Goldman Sachs’ economists call a sharp worsening in “housing affordability”.

Market data are not much help. The prices of new homes are declining in the face of rising inventories of unsold houses, and the need of highly leveraged builders to meet rising interest payments. The Washington, D.C. area is particularly hard hit, with listings up and sales down, according to Metropolitan Regional Information Systems, Inc. Some builders around the country are offering inducements such as free golf-club memberships to

persuade hesitating buyers to sign on the dotted line. But prices of existing homes are firmer, as owners are in a position to sit tight rather than accept offers they consider too low.

Using the quite sensible economic proposition that “no tree grows to the sky”, we can assume that the days of double-digit increases in house prices are over. But that does not mean that the housing market is likely to collapse.

Toll Brothers attributed its non-growth in good part to higher energy prices and a decline in consumer confidence. A few days after the company’s announcement gasoline prices turned down, as did natural gas prices, and the University of Michigan announced a rise in consumer confidence, although not to pre-Katrina levels.

That’s the good news. The less good is that it is reasonable to assume that consumers will not tap into the value of their homes next year to the extent they have in the past. That means we have to count on business investment to pick up the slack. The business sector is clearly in a position to do just that. Corporate profits have been “on a five-year tear” according to Goldman Sachs, grew at a double-digit rate in the first three quarters of this year, according to Thomson Financial, and will continue to do so into 2006, according to Banc America Securities. With unit labor costs rising at historically modest rates, and corporate “pricing power” on the rise, healthy bottom lines are the order of the day.

But companies are cautious. Fuel costs remain high. Interest rates are rising. Tightening labor markets may drive compensation up too fast to be offset by productivity gains. Debt-ridden

consumers may finally rein in spending and start saving, especially when the shock of higher heating bills hits. The political situation is unsettling, with President Bush's waning strength threatening his ability to persuade congress to make his tax cuts permanent. Most important, the Fed is determined to slow real growth, and few businessmen are prepared to bet against the Fed.

So the increase in business investment has slowed from the 12%-14% range to 8%-9%, not enough to make up for a sharp fall in consumer spending should consumers decide to refrain from tapping into the still-substantial equity in their homes as freely as in the recent past.

Confused? You're not alone. So for now stick with the Fed and assume that the economy will continue to grow at a rate of around 3.5%.



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