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ECONOMIC NEWS UPDATE

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Americans' obsession with house prices remains undiminished. Indeed, now that it is becoming obvious that prices can move down as well as up, anxiety has increased the intensity of that obsession.

For good reason. For non-millionaires, their homes are more than their castles. Homes are the largest asset in their portfolios. Interest in the US housing market extends across the ocean. Also, many Brits have second homes in Florida, the land of sunshine and beaches for mom, golf courses for dad, Disney World for the kids, and 40% annual appreciation for the entire family.

The beaches, golf courses, and theme parks are still there, but the annual appreciation isn't. The sellers' and renters' market has turned into a buyers' market: vacancies are up, the inventory of unsold houses and condos is rising, and prices are down, especially for what Paul Purcell, of real estate (property) consultants Braddock + Purcell calls "vanilla properties" -- those with locations and architecture that are "not great".

Fortunately for many American homeowners, south Florida is not America. It is, instead, one of the areas in which buyers somehow decided that prices were on a get-rich-quick, one-way escalator. Another is Las Vegas, where developers are scrambling to shelve plans for the construction of new condos. In other areas the market remains strong. Houston, Atlanta and Dallas did not experience the wild upward price spiral, and are not experiencing the rising inventories that are causing builders and sellers such pain elsewhere.

Freddie Mac is a big player in the housing market, providing liquidity to mortgage markets by buying one mortgage every seven seconds. Its vice president and chief economist, Frank Nothaft, says the housing market is witnessing "a moderate and orderly slowing". To put the current softening into perspective, he points out that new construction and sales of houses this year will be the third highest in the nation's history, after the boom years of 2004 and 2005. Consultants at RealEstateabc.com, a consumer

information website, agree: "If it weren't for the high expectations of the last sales cycle, this might actually be a 'normal' market."

So don't abandon hope all ye who have entered the housing market. Yes, some areas are loaded with unsold inventory and distressed sellers. But in places like Manhattan the best properties are still snapped up after a bidding war among buyers, and in other cities sales are slower, but prices are firm.

Add all these disparate regions together, and the picture is grimmer than sellers would like it to be, but just about what the Federal Reserve Board, eager to engineer an inflation-stifling slow-down, says it is pleased to see. Housing starts in the US in July declined 13% from the previous year. JP Morgan finds this "consistent with a continued worsening of homebuilder order trends through July, as well as continued increases in inventory levels in several key markets.... Total permits, a one-month leading indicator of starts, continued to decline at an even stronger rate...". This comes as no surprise to Nothaft and his colleagues Amy Crews Cutts and Nela Robinson. In their monthly review of the economic and housing outlook, they point out that "upward pressure on mortgage financing costs, ... coupled with high house prices reduce affordability and lower housing demand."

Whether this demand drop-off is a normal adjustment en route to a soft landing in the housing market, or the beginning of a crash, is in the eye of the beholder. Investors in homebuilder shares probably feel as if they have already been through a crash. Analysts at Citigroup Global Markets estimate that the current median share price of a

group of 13 homebuilders has fallen by almost 50% from its 52-week high. And there is no question that the consequences of the decline in housing will extend beyond that industry, and reach into the overall economy.

Moody's Economy.com reports that from the start of 2001, when Alan Greenspan began the round of interest rate cuts he deemed necessary to fight the recession, the housing sector added 1.1 million jobs, almost offsetting the loss of 1.2 million jobs in the rest of the economy. And in the first half of this year residential fixed investment and housing construction accounted for about 6% and 10%, respectively, of GDP growth.

There are two ways that the softening of the housing market will affect the economy. The first is obvious. The construction industry will need fewer workers, buy less lumber, cement and other building materials, and generally reflect the increasing pessimism of the homebuilding industry's CEOs, who are pulling in their horns. In the last quarter, real (inflation-adjusted) residential investment fell at an annual rate of 6.4%, following small declines in the two preceding quarters.

The second effect of the weaker housing market will be -- well, may be -- on consumer spending. For one thing, consumers who see the value of their houses decline will feel poorer, even if they have no intention of selling. That may explain the recent drop in consumer sentiment. And their ability to tap the steady increases in the value of their homes by "mortgaging out" to fund current consumption will be a thing of the past.

Most analysts are predicting that consumers, deprived of the feelgood factor and of an important source of

buying power, will avoid gas-consuming trips to the malls, and save a larger portion of their incomes, which finally seem to be rising faster than inflation. But “business at auto dealers and other retailers picked up in July,” according to Goldman Sachs. Victoria’s Secret reported a rise in July sales, and booksellers Barnes & Noble a small drop, perhaps portending a change in the nature of Americans’ leisure activities.

It is, of course, too early for changes in house prices to affect consumers’ daily purchases. If forecasters are right that the flow-through effect will be felt later this year and in 2007, America’s economic growth rate will drop to somewhere between 2.0% and 2.5%, and the unemployment rate will rise to perhaps 5.5% by year-end 2007 -- a forecast that the President’s economists say is excessively pessimistic. They think the economy will grow at between 3.0% and 3.5% in the foreseeable future.

If the low-growth scenario does materialize, inflation will be slain, the Fed will lower interest rates, and growth will accelerate in 2008, just in time for the presidential elections. That, at least, is what Republicans, almost certain to lose control of the House of Representatives later this year, are hoping if they can’t get their real wish -- continued rapid growth.



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