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ECONOMIC NEWS UPDATE

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Surprises, they come to economists not singly, but in battalions. Just when many analysts were cranking out reports of a peak in oil production, and a permanent new era of \$80 or \$100 oil, crude oil prices fell by about 25%. The multiple surprises that produced this drop include:

- A Saudi plan to increase production capacity by 1.5 million barrels per day even though it presently can't sell all the oil it produces;
- New unanticipated discoveries in the Gulf of Mexico and in non-OPEC countries, adding several million barrels per day to supplies;
- A drop in demand for oil as the US economy slows; and
- A fall in the risk premium as it has become clear that the UN Security Council prefers a nuclear-armed Iran to sanctions.

But just as those surprises were absorbed in forecasts, along came another: the OPEC oil cartel quietly passed the word to its members that output reductions are not a bad idea if

prices are to be maintained at a level it could only dream of a few years ago, but to which it has now grown accustomed. Result: an uptick in oil prices. More surprises are undoubtedly in store, as the Saudi royal family decides whether to shore up crude prices by cutting back production, surrendering hundreds of millions of dollars in revenues it needs to fund social programs.

The housing market also continues to surprise. Sales of new homes are down 17% from a year ago, and sales of existing homes by 12%. With inventories of unsold homes at a 13-year high and rising, it is no surprise that prices are finally dropping. But just as most analysts decided that the market had gone from cool to frigid, with dire consequences for the overall economy, the August figures provided another surprise. Sales of new homes rose by 4.1%. One data point does not make a trend, so it would be foolish to say that the bottom has been reached in a market in which prices are still estimated to be 25% above levels that can be sustained by current incomes.

But the recovery in sales, which sparked a bit of a recovery in shares of home builders, is a reminder that there is more at work in this market than is immediately apparent.

For one thing, mortgage rates are falling and real incomes are rising, giving a bit of strength to demand. And consumer confidence provided another surprise: it took a significant leap in September, as consumers' views of the job market and their earnings outlook grew cheerier, and a 60 cents-a-gallon drop in gasoline price added \$78 billion to Americans' purchasing power, according to Morgan Stanley economists, and joy to beleaguered Republican candidates for congress.

The biggest surprise of all has been the stock market, which has been flirting with record highs. With the housing market in decline, and labor costs rising at a rate of about 5% as compensation gains (about 8%) outstrip productivity improvements (about 2.5-3%), the bears were prepared to rampage down Wall Street. In the event, they have been gored by the bulls.

Explanations for this surprise vary. Some say that the continued strength of profits (up 20% in the second quarter over last year) and cash flow have resulted in a general undervaluation of shares, a view held by 35% of money managers surveyed by the Russell Investment Group, which manages over \$170 billion in assets. Others think that the slowing economy makes it certain that the Federal Reserve Board's monetary policy committee will either end the ratcheting up of interest rates, or soon begin to lower them. Still other bulls expect the dollar to drop like a stone, providing new opportunities for export industries, for made-in-the-USA goods, and for leisure

and entertainment industries as more and more consumers fill their tanks with cheaper gasoline, and tour the US rather than fly off to Europe.

The dollar, of course, remains another source of surprises. It is weakening, but it has not collapsed, and even jumped higher on news of rising consumer confidence, despite International Monetary Fund fears of "a disorderly dollar adjustment", and despite accumulating downward pressures such as these:

- Treasury Secretary Hank Paulson was unable to persuade his many friends in the Chinese government to allow a significant appreciation in the renminbi. No surprise there. But the Chinese did surprise by passing the word that they have stored just about as many pictures of US presidents in their bank vaults as they deem prudent, suggesting that they will diversify their reserves away from dollars.
- All signs point to an increase in interest rates in euroland while US rates remain unchanged or fall. That will make it relatively more attractive to hold euro-denominated assets, and further weaken the greenback.

Finally, we have the surprise of continued growth. The economy has slowed but not stalled. Edward Lazaer, chairman of the President's Council of Economic Advisers told a Senate committee last week that he expects growth to slow in the remainder of this year, but proceed "at a robust pace in 2007 and beyond". He reported that "weakness in the housing sector does not seem to be spreading to other sectors of the economy".

More surprises are in store, not all of them on the economic front. In the political arena, Republicans will be surprised if they fail to retain control of the Senate, and Democrats will be astonished if they prove unable to ride a wave of dissatisfaction with the prosecution of the war in Iraq into control of the House of Representatives. And on the home front, lots of Americans will be surprised when they find that they can't get the prices for their homes that were theirs for the taking only a few months ago.



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