Popular Economics Weekly

WEEK OF DECEMBER 20, 2005—2006??

What will happen in 2006? The economic signals are conflicting at the moment. Falling oil and gas prices have brought down inflation, but economic growth is still averaging 3.7 percent in 2005, slightly above so-called 'trend' growth that Fed Governors believe is neutral—i.e., maximum growth without excessive inflation. Though growth is still a tad high for the Fed's comfort, they removed the word "accommodative" from the Dec. Federal Open Market Committee press release. This means they believe that interest rates have risen enough that rates are no longer accommodative—meaning too stimulative to economic activity.

But some clues to the 2006 economy are in the final third quarter Gross Domestic Product estimate just out. Third quarter growth averaged a robust 4.1 percent, the highest growth rate since Q1 of 2004. This was mainly thanks to busy consumers and government spending. But it was less than preliminary estimates because business continued to draw down inventories rather than replenish them, hardly a sign of business confidence for next year. And this is the Christmas season!

One reason for diminished business confidence was fewer exports and rising imports in Q3. This could be because of high oil prices, of course, but it also means fewer goods and services produced in the U.S. of A. (and more produced overseas), hence slower employment growth.

Another reason for next year caution is our personal savings rate. Though personal income and spending both rose a substantial 0.3 percent in November, savings remained negative, meaning that consumers continue to spend more than they earned. Why do they continue to spend, therefore? Real estate is still holding its value, with both new and existing-home prices rising 16 percent in a year, so that the total amount of home equity in just owner-occupied housing is now a record $10.3 trillion (despite all the borrowing), according Fannie Mae's chief economist, David Berson.

Berson also reported that second and third quarter mortgage debt outstanding grew 15 and 15.9 percent, respectively, the biggest increase since 1979, in his most recent (Dec.) monthly outlook. And growth in home equity loans continued high, up 24 and 16.2 percent in Q2 and Q3, respectively, according to Berson, though down from last year's 36 percent average. So consumers continue to tap into their home equity, from which they borrowed more than $600 billion last year.

We see only slightly less home borrowing next year, because Fannie Mae and Freddie Mac raised their maximum conforming loan amounts 16 percent to $417,000 for a single residential unit. Conforming loans have a slightly lower interest rate, which could stimulate additional borrowing. Berson, though, sees a drop of 25 percent to $2.1 trillion in originations for next year, from this year's $2.8 trillion. A total $3.6 trillion borrowed in 2004, surely the record for years to come.

Other indicators showed the economy perking along at or close to capacity. Industrial production continued to climb, even with slumping auto sales, and capacity utilization at 80.2 percent is approaching the long term high mark. Then the Conference Board's Index of Leading Indicators jumped, even though the Board continues to discount the flat Treasury yield curve as an indication of slower growth ahead. The 2-year Treasury Bond yield surpassed the 10-yr Bond this week for the first time since 2000.

LEADING ECONOMIC INDICATORS—The Conference Board's index rose 0.5 percent, and is now increasing at a 3.4 percent annual rent, compatible with "moderate" economic growth. Seven of its ten indicators increased, including the money supply, which has been expanding again after decreasing for most of 2005. Why is a mystery since the Treasury yield curve continues to flatten, with the spread between the 10-year Bond and fed funds overnight rate now down to .54 percent, from as high as 1.14 percent in May 2005. The narrowing spread cuts into banks' profit, since they borrow short-term and lend at long-term (fixed) rates. A flat money supply means less money in circulation, and so less money for consumers to spend, banks to lend, and investors to invest.

HOUSING STARTS—Again soared to a new record of 2.12 million annualized units in November. Only multi-family construction fell 14.8 percent, which is continuing a trend from the 1990s when rental vacancy rates were highest. The caveat is that average 30-year fixed rates have risen to 6.3 percent, according to Freddie Mac; they were 5.68 percent last year at this time. This could reduce demand, which is why home sales are predicted to decline next year.

INFLATION—The wholesale Producer Price (PPI) and retail Consumer Price (CPI) indexes plunged 0.6 and 0.7 percent, respectively. This was due to falling oil and gas prices, of course. Core inflation barely rose, meaning that producers are still not able to pass through their costs to consumer prices. But the CPI is still rising at 3.5 percent per year, which is better than October's 4.3 percent inflation rate.

Fannie Mae's Berson believes much of the inflation is temporary due to the hurricanes, and still robust home sales are due to a "continued rise in investor demand that has pushed home sales and prices to unsustainable levels." He therefore predicts that overall 2006 sales will slip to 7.14 million units, down by 5-10 percent from this year's record level of 8.31 million units.

It is a no-brainer that the direction of interest rates will ultimately determine the direction of home prices and sales. Home buyers and borrowers have been able to sustain their purchases because lenders have eased their lending standards in this era of easy money, while dreaming up negatively amortized adjustable rate mortgages (ARMs) with ridiculous start rates as low as 1 percent. And so adjustable rate mortgages now are 33 percent of all mortgage applications, according to the Mortgage Bankers Association (and comprise more than 48 percent of dollar volume). This is also unsustainable, should short-term rates continue higher in 2006.