Popular Economics Weekly

WEEK OF DECEMBER 26, 2005—SURVIVING CHRISTMAS

Real estate has survived another Christmas, in spite of the dour predictions of a housing bubble. Home sales are set to break the record again, with Fannie Mae's chief economist David Berson predicting 8.31 million total units sold for all of 2005. This is in the face of earlier predictions that 2005 could signal the end of good times for real estate. We would begin to hear a hissing sound as property values began to fall, in other words, if not the popping of housing bubbles! Berson originally predicted that just 7.14 million units would sell this year. And mortgage volume should total $2.8 trillion, whereas Berson predicted $2.15 trillion.

Why the difference? Fixed mortgage rates averaged 5.87 percent, for starters, the same as last year, according to Freddie Mac, even though the Federal Reserve has tightened their short-term bank lending rate 13 times since mid-2004, from its low of 1 percent to 4.25 percent. This has led to short-term interest rates rising to the level of the 10-year Treasure Bond, which no one predicted. If short-term rates continue to rise above 10-year Treasury Bond yields for any length of time (more than a few months, that is), it could mean a recession. This has happened every time since World War II. It's what is called an inverted yield curve.

Secondly, consumers have not stopped spending with 2 million jobs created this year, buoying consumers' confidence as well as their pocketbooks. Consumers were also cheered just in time for Christmas by lower energy prices that have brought down inflation since the hurricanes.

And let us not forget some demographic trends that show almost 80 million echo-boomers (i.e, children of baby boomers born 1980-96) beginning to enter the housing market, thus keeping housing in demand.

Lastly, it really seems as if we have remained in a 'not to hot, not too cold' goldilocks economy, in part because the Fed's tightening policy combined with natural disasters, and higher energy costs have kept the economy from overheating and so inflation as well. Yet the demand for real property remains red hot, which Berson maintains is not sustainable. Prices are rising 16 percent per annum, even though housing inventories have been creeping up. There is now a 5-month inventory of existing-homes for sale, up from a 4.4-month supply earlier in the year.

The consumer confidence rebound since the hurricanes is also a reason for optimism in 2006. But what will they spend their money on? Probably real estate, what with a flat stock market and bond prices still at historic highs, since it is the ultimate safe haven. Home sales held up in December, normally a cold month for sales.

CONSUMER CONFIDENCE—Confidence jumped in both the U. of Michigan and Conference Board's surveys. Michigan's twice monthly telephone survey rose 10 points to 91.5 in Dec. "Declines in gas prices were responsible for the substantial gain, which nearly restored confidence to the levels recorded prior to the spike in gas prices last August," said Richard Curtin, Director of Consumer Surveys.

The Conference Board's Dec. survey improved to 103.6. It had bottomed out during the hurricanes, but is almost back to its June '05 peak. But consumers remained cautious about future business conditions, especially the availability of jobs.

HOUSING—November new-home sales fell 11 percent to 1.25 million seasonally adjusted units from October's record sales. Inventories rose to a 4.9 month supply, while the median price rose just 0.3 percent to $225,200.

Existing-home sales also fell slightly to 6.97 million seasonally adjusted units, according to the NAR's chief economist, David Lereah, and a 5-month supply remains on the market. He expects 2005 will set another record with 7.1 total million units sold. In fact, the median sales price rose 13.2 percent in a year to $215,000, but has been flat since June. This signifies that the housing market has peaked, said Lereah.

The New Year's biggest debate will be whether Fed Chairman-elect Ben Bernanke implements his proposed inflation rule that says the Fed must keep core inflation within the 1-2 percent. Since inflation rose much higher during 2005 thanks to our profligate energy ways, what would that mean to economic growth? Bernanke could conceivably advocate more drastic tightening.

Why use a prescribed inflation rule anyway? Because studies show that consumers' perception of inflation helps determine the inflation rate! I.e., they will drive up prices, if they think prices are rising anyway and spend less if prices decline. This all relates to the amount of money in consumers' pockets, of course. So if the Fed "commits' to a pattern of behavior that avoids the temptation to ease policy at the expense of inflation, for example, consumers will expect that and not be willing to drive up prices, is the theory.

Consumers may already be convinced that inflation will remain in check, given the plentiful supply of cheap imports from Asia. Fannie Mae's Berson predicts that core inflation will continue to decline in 2006. But one must watch energy prices, since another spike could kick inflation into a gallop again.