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WEEK OF AUGUST 29, 2005—WILL KATRINA ALTER FED POLICY?

> "Every (economic) model, no matter how detailed or how well conceived, designed, and implemented, is a vastly simplified representation of the world, with all of the intricacies we experience on a day-to-day basis."
>
> Alan Greenspan—Jackson Hole symposium, August 26, 2005

No one has yet given a convincing answer to the conundrum posed by long-term interest rates that decline while the U.S. economy continues to expand—especially real estate. Pundits have been predicting 6 to 7 percent 30-year fixed mortgage rates by the year's end as they did in 2004 when Gross Domestic Product growth averaged a hot 4.2 percent. Yet fixed rates reached 6 percent only briefly last summer.

The answer could be that too much geopolitical uncertainty, or sky-high energy prices, or some unusual monetary factors has kept bond yields low. This is in spite of record housing sales and prices, as well as the Federal Reserve's attempt to tighten credit by raising short-term rates. And now the catastrophic damage from Hurricane Katrina could boost energy, lumber, cement and other commodity prices even higher.

We also cite Chairman Greenspan's above quote. Existing economic models on which most economists base their predictions don't fit current circumstances. In the past, when the Federal Reserve began tightening credit—whether raising short-term interest rates, or using other means to shrink the money supply—it has caused long term interest rates to follow suit.

But squeezing the money supply has not been easy when the Fed's own monetary policy contributed to the excess of liquidity—at the same time that foreigners seem to have a surplus of savings. And so prices in almost all asset classes are soaring—whether commodities (e.g., oil), real estate, or bonds. Foreign investors want to invest in U.S. assets; whether stocks, bonds or real estate. Even stock equities have appreciated an average 10 percent per year since 1995, according to Dr. Greenspan.

Yet the Fed Chairman keeps suggesting that so much confidence in U.S. assets may be due to over exuberance. "This vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk," he said at Jackson Hole. "But what they perceive as newly abundant liquidity can readily disappear…This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

Will Hurricane Katrina's aftermath cause the Federal Reserve to pause in its rate hikes? Second Quarter economic (GDP) growth slowed, and incomes were stagnant. Consumer sentiment was mixed in August—down at the U. of Michigan, but higher with the Conference Board. This is before the current spike in crude oil and natural gas prices caused by Katrina, however, which is adding at least 30 cents per gallon to gasoline prices.

CONSUMER SENTIMENT—"Rising prices were expected to completely offset income gains by four-in-ten households in August, the highest level in more than ten year," said the U. of Michigan survey director Richard Curtin. Its index consequently fell to 89.1 from July's 96.5. The Conference Board's Confidence Index improved to 105.6, on the other hand, with more consumers saying that jobs were "plentiful".

GROSS DOMESTIC PRODUCT—Q2 growth was revised downward from 3.4 to 3.3 percent, mainly due to higher import prices—meaning expensive oil. Inventories also fell, meaning that producers weren't replacing what they sold! Core personal consumption inflation fell to 1.6 percent, moderating from the worrisome 2.4 percent annual rate in Q1

HOUSEHOLD INCOME—The Census Bureau reported that the 2004 median household income was flat for the second consecutive year, at $44,389. This is why consumers' personal savings rate has fallen below zero. While personal consumption rose a huge 1 percent in August, personal incomes rose just 0.3 percent. Hence the minus 0.6 percent savings rate, a danger signal for the economy. The spending binge was therefore done on borrowed money. The only remedy in the Fed's monetary arsenal is to continue to raise interest rates, so consumers will spend less and save more—until incomes catch up.

It is the boom in housing values that has kept consumers spending and the economy robust. Freddie Mac reported that $59 billion was extracted from refinancing to a larger mortgage in the second quarter, on top of $50 billion per quarter over the past year from home equity loans. This is with current 30-year conventional fixed rates in the 5.375 percent to 5.625 percent range. Only in 2003 did fixed rates dip lower.

Total mortgage originations continue to exceed expectations. Fannie Mae estimates that single-family mortgage volume will top $2.7 Trillion in 2005, up from its initial estimate of $2.6 Trillion. Total mortgage debt soared 9.2 percent annualized to $8.9 Trillion in the first quarter, according to Fannie.

But the Federal Reserve could cause real economic damage if it persists too long in raising short-term interest rates—precipitating what is called an inverted Treasury yield curve. There has been a recession every time short-term interest rates have climbed above long-term rates since World War II, according to economist Irwin Kellner. It last happened in 1999, and the 2001 recession followed.

But given the innate caution and frequent warnings of Fed Governors that they are prepared for every exigency, we think policy makers will err on the side of caution should signs of an economic slowdown appear. This could occur with the aftermath of Hurricane Katrina. Or, given the importance of the real estate industry to our economic well being, any slowing in real estate sales might be another sign that would cause the Federal Reserve to take their foot off the economic brake.