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Will Q3 Growth Slow?

It is time to look at the prospects for third quarter growth, a crucial time that could determine what happens for the rest of 2007. Two factors make this quarter of interest: Fed Chairman Ben Berrnanke suddenly lowered his expectations for inflation and economic growth in his latest congressional testimony, and the subprime market continues to have problems. This seems to take any possibility of further Fed rate hikes off the table this year.

The cause of his change of heart may be that credit rating agencies such as Standard & Poor's and Moody's downgraded to junk bond status at least $10 billion in so-called mortgage backed securities (MBS) and other credit instruments that back subprime mortgages. The reason? Massive defaults are exposing the sloppy underwriting and accounting practices of not only subprime lenders, but the Wall Street firms that underwrote their business.

"The downgrades come because S&P said losses on such mortgage-backed securities will "significantly" exceed anything that's happened before and its own expectations," reported CBS Marketwatch.

Both of these occurrences can be good for real estate, since bond markets rallied on the lessening inflation threat. The 10-year benchmark Treasury bond yield dropped below 5 percent for the first time in months.

The earliest actual indicator for Q3 growth is the Conference Board Index of Leading Economic Indicators (LEI) that came out this week. It fell 0.3 percent in June, and has declined 1.3% annualized over the past six months, suggesting that "economic growth is likely to continue, but it is likely to be at a slow pace in the near term," said the Conference Board release.

It is a pretty good predictor for second-half growth, since it incorporates many of the factors that control growth, such as the money supply, consumer expectations, and manufacturing output.

June's inflation indexes were also benign, just as Bernanke has predicted. Wholesale PPI prices actually fell 0.2 percent, surprising analysts, and retail (CPI) prices rose 0.2 percent, because energy costs softened. Only auto and food prices rose; autos because Detroit is introducing its new season models and food prices because of the wholesale diversion of corn for the making of ethanol.

Housing starts for June rose slightly, but building permits continued to decline. This could be a sign that housing demand is solidifying, even though the National Association of Builders' sentiment index for future business sank to its lowest level since 1991.

Bernanke's congressional testimony was really an admission that the Fed is becoming worried over the damage the subprime debacle could do to real estate and banks. This can only continue to bring down interest rates and so hearten home buyers who now have a large inventory of homes for sale to choose from.

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