

WEEK OF OCTOBER 30, 2006—NO GOLDILOCKS ECONOMY?

There are dissenters to the rosy soft-landing scenario voiced by such as former Fed Chairman Alan Greenspan, who repeated Fed Vice-Chairman Kohn's remarks that housing sales and prices had probably bottomed, after last months (slight) rise in builders' confidence and the 5 percent rise in new-home sales.

Its main critic is NY Times economist Paul Krugman, who believes that the sharp drop in housing construction has only begun, with its consequent effect on construction jobs and subsidiary sectors of the economy. This could bring economic growth down to the single-digits next year. (That in fact has already happened for the initial estimate of Q3 GDP growth.)

Another is Merrill Lynch economist David Rosenberg. His latest report states his case:

"The "soft-landers" were pleased by the September housing starts report, which defied expectations and rose by 5.9% to 1.772 million units (annualized). That was another data point purportedly validating the view that housing has bottomed out," he said. "The problem, however, is that the demographics of the U.S. support a starts level of only 1.6 million units. Moreover, with the backlog of unsold homes as high as it is, our research suggests that this housing cycle won't bottom until starts reach the 1.3-million mark."

Lastly, Pimco Bond Fund Managing Director Paul McCulley believes the housing market is already in recession. "The consensus at our September Forum was that the recession in the U.S. housing sector—and, yes, it is fair to call that sector in recession—will be nastier than expected, both directly in terms of residential investment and indirectly via the effect on consumption," he said in his latest comments.

Bolstering these pessimists are this week's economic reports that have caused bonds to rally and the 10-year Treasury yield to fall to 4.55 percent. Firstly, the National Association of Realtors reported that pending home sales, an indicator of future sales, had fallen another 1.1 percent in Sept. and is down 13.6 percent over September 2005.

Then residential construction spending fell 17 percent in the preliminary third quarter GDP estimate, bringing Gross Domestic Product growth down to 1.6 percent, from 2.6 percent in Q2 and 5.6 percent in Q1 2006—almost a screeching halt.

Lastly, manufacturing activity fell to a 3-year low, as new orders, output and prices fell and inventories rose. Consumer confidence also declined slightly in the latest Conference Board survey. It "was prompted by consumers' mixed assessment of present-day business conditions and a less favorable view of the job market," said the press release.

Greenspan actually said, "I suspect we are coming to the end of this downtrend, as applications for new mortgages, the most important series, have flattened out." Mortgage application volumes have declined about 20 percent from the peak, in line with the rise in interest rates. Now that rates have stabilized, due to the Fed's inaction in its past 3 FOMC meetings and a bond market rally that believes the economic slowdown will keep

inflation in check, we see mortgage applications stabilizing. But any more interest rate hikes by the Fed, or signs of higher inflation will certainly scare bond traders.

Pimco's McCulley believes anyone who thinks a small improvement in interest rates will bring back the housing boom is "delusional", says CBS Marketwatch, in an interview with McCulley. "Housing is going to be very inelastic (i.e., resistant) to falling interest rates on the way down, just as it was very inelastic to rising rates on the way up."

Real estate is the ultimate momentum market, says McCulley. Investors "Can't get enough on the way up and can't run away fast enough on the way down."

How do we judge its momentum on the way down? Several economists have constructed a "real" mortgage rate adjusted for housing inflation, rather than consumer prices. When housing was rising 16 percent per year over the past 2 years and interest rates were in the 6 percent range, the real interest rate was a minus 10 percent (I.e, it was rising 10 percent faster than the cost of money)! This means that what were already abnormally low interest rates were adding in effect 10 percent to housing price appreciation.

Today, with housing prices having fallen 2 percent year-over-year and interest rates still at 6 percent, we now have a 'positive' interest rate of 8 percent. This is in effect deducting 8 percent from price appreciation. The 'real' point? That prices have further to drop, as do home sales. Prices could decline another 8 percent per year, or maybe further, until the supply of homes comes more into balance with demand.

What is the conclusion of Merrill Lynch's Rosenberg? "The National Association of Home Builders (NAHB) housing market index rose a full point in October to 31, from 30 in September. That one-point rebound followed eight months of declines, and the index remains near a 15-year low. In other words, that was all that the housing market could muster despite a sizable drop in mortgage rates in recent weeks," he said. "That is a vivid sign that lower interest rates alone will not revive the housing market; it will take a deeper production adjustment by home builders and larger price concessions before the excess inventory of 1.5 million units is worked off and supply and demand comes into a better balance."