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WEEK OF SEPTEMBER 19, 2005-- THE FED SPEAKS

Fed Chairman Greenspan tossed a bone to the real estate market in a recent speech to the American Bankers Association annual convention. Though the use of so-called hybrid mortgages—that combine fixed and adjustable rates—has increased and perhaps been instrumental in soaring home values, even a substantial drop in said values should not appreciably endanger consumers or overall economic activity.

Why? Because Greenspan's research indicated that "only a small fraction of households across the country have loan-to-value ratios greater than 90 percent. Thus, the vast majority of homeowners have a sizable equity cushion with which to absorb a potential decline in house prices."

And, LTVs appear to be lower in those states such as California and Massachusetts that have experienced the largest run-up in values, and so could be most at risk for a substantial market reversal. This is in part because of the huge increase in housing equity in the coastal states. The market value of owner-occupied homes nationally has risen approximately 9 percent per year over the past decade, from $8 trillion at the end of 1995 to $18 trillion in June of this year, according to the Federal Reserve.

The Federal Reserve's Open Market Committee (FOMC) decided at its Sept. 20 meeting to raise the overnight fed funds rate one-quarter percent to 3.75 percent. The irony cannot be lost on us that while the Fed attempts to tighten credit, the Federal government is becoming ever more accommodative with its credit. President Bush has promised that the government will do "whatever it takes" to rebuild the Gulf Coast, but without raising taxes.

"The widespread devastation in the Gulf region, the associated dislocation of economic activity, and the boost to energy prices imply that spending, production, and employment will be set back in the near term. In addition to elevating premiums for some energy products, the disruption to the production and refining infrastructure may add to energy price volatility," said the FOMC press release.

But, "While these unfortunate developments have increased uncertainty about near-term economic performance, it is the Committee's view that they do not pose a more persistent threat," said the release. The vote was 9-1 to continue to squeeze consumers' borrowing ability. The Prime Rate has now risen to 6.75 percent, and is expected to continue upward. By way of comparison, it topped 9.5 percent in 1999, before the Fed's actions burst the stock market bubble of 2000.

The Conference Board's Index of Leading Economic Indicators for August (i.e., before Katrina) was not so sanguine about next year. Its leading index decreased 0.2 percent, a second consecutive drop. The main negative was a fall in consumer expectations, which could be based on the higher energy prices. The hurricane damage to refineries could further exacerbate consumer concerns.

So the jury is still out on the affects of Hurricanes' Katrina and Rita. August new-home construction sank only slightly, to an annualized rate of 2 million units. More than 2.12 million new building permits were authorized. This is also before any accounting is made for the rebuilding of literally "hundreds of thousands" of homes destroyed by the hurricanes, according to the Commerce Dept.

The 30-year fixed mortgage rate is currently vacillating from 5.50 to 5.75 percent, which is about one-half percent below its level in late spring of 2004. "The enormous increase in housing values and mortgage debt has been spurred by the decline in mortgage interest rates, which remain historically low," said Dr. Greenspan in his speech. "This decline in mortgage rates and other long-term interest rates in the context of a concurrent rise in the federal funds rate is without precedent in recent U.S. experience."

Be that as it may, Standard & Poor's Chief Economist David Wyss believes that the hottest real estate markets must eventually cool. Why? The average U.S. home price is almost 3.1 times the average household income, highest in history and up from an average of 2.6 time since 1960, according to S&P.

But it will be a steady deceleration of prices followed by stabilization, rather than a dramatic national downturn. "The coming rebalancing period could last half a decade, because it will take a 20 percent correction nationally to restore the normal ratio of home prices to incomes," said Wyss.

There are few signs of a slowdown just yet. Delinquency rates of loans more than 30 days overdue have dropped from 2.39 percent in 2001 to 1.4 percent today, for example. And the National Association of Realtor's affordability index that measures median income relative to the monthly payment for a median-priced home is at its highest level since the early 1970s.