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WEEK OF OCTOBER 24, 2005—WHICH DIRECTION FOR INTEREST RATES?

Why did President Bush anoint Princeton Professor Ben Bernanke the new Federal Reserve Chairman? Pundits are speculating all over the map; from the fact that he is a Republican, and a former Fed Governor, to being the White House's chief economic advisor. (But very few Fed Governors, who are central bankers after all, have been Democrats—at least in recent history.)

Some clues have popped up from his past record that might tell us why Bush chose him, as well as hint at the future direction of interest rates—especially crucial to real estate investors. He has specialized in studying the Great Depression and written extensively about it. It was a time of great deflation, and that means many people (and governments) were unable to pay their debts, which is why so many banks failed.

Bernanke therefore seems to see a greater danger in deflation than inflation. Republicans like that bias, since it means a more liberal monetary policy for business. He was one of the main advocates of the Fed's easy money policy in 2001-2003 that kept consumers spending, in spite of the danger of higher inflation.

Secondly, he is reputed to have engineered the current low interest rates by convincing Japan and China to buy our Treasury Bonds with their excess dollars as a Fed Governor. This is when conventional economic wisdom would dictate that our huge budget deficit should cause much higher long-term interest rates. It has kept the interest costs down on the deficit and so helped the White House to finance its budget deficit.

Lastly, not being an inflation hawk means that he is willing to push the economy towards higher growth (and more jobs), which is just what the supply-side economists who engineered the Bush tax cuts want. They maintain it is the inflation hawks including Chairman Greenspan that are putting the brakes on consumer spending at the moment.

We therefore see a more accommodative monetary policy next year when Bernanke takes the helm as the new Fed Chairman. This means the Fed will probably pause in their interest rate hikes and maybe begin to reduce them, if economic activity slows as predicted in 2006.

More monetary accommodation may be necessary because of the continued fall in consumer confidence documented by the Conference Board. Its October gauge fell to 85 from 87.5 in Sept., mostly due to pessimism about jobs.

CONSUMER CONFIDENCE—"Much of the decline in confidence over the past two months can be attributed to the recent hurricanes, pump shock and a weakening labor market," says Lynn Franco, Director of The Conference Board Consumer Research Center. "Consumers' assessment of current conditions, however, remains above readings a year ago, but their short-term expectations are significantly below last October's level. This degree of pessimism, in conjunction with the anticipation of much higher home heating bills this winter, may take some cheer out of the upcoming holiday season. In order to avoid a blue Christmas, retailers will need to lure shoppers with sales and discounts."

EXISTING HOMES—Sales of existing homes nationally remained at the second highest pace on record in September, with the highest sales in the South following Hurricane Katrina, according to the National Association of Realtors.

Total existing-home sales – including single-family, townhomes, condominiums and co-ops – were at a seasonally adjusted annual rate of 7.28 million units in September, unchanged from August. Sales were 7.2 percent above the 6.79 million-unit level in September 2004, and were second only to a rate of 7.35 million in June of this year.

David Lereah, NAR's chief economist, said spiking home sales in areas surrounding the Hurricane Katrina disaster zone supported near-record activity. "We are now getting some hard data from this region, with spot checks showing sharply higher home sales to residents who were displaced by the hurricane. The sales surge is more than offsetting declines in the disaster zone," he said.

NEW HOME SALES—Were a bit disappointing. Sept. national sales increased 2.1 percent over August, but inventories of unsold homes also rose to a record 493,000 units, or a 4.9-month supply at the current sales rate. This has to put pressure on housing prices. The national median-price rose just 1.9 percent year-over-year to $215,700. It has been rising much more slowly than the existing-home median price, which rose 13.4 percent to $212,000 in Sept.

HOUSING SCARCITY—The real reason for soaring real estate prices is the relative scarcity of new homes being built, say the authors of a new National Bureau of Economic (NBER) research paper. That is, fewer homes are being built relative to the existing housing stock. And that scarcity is manmade, thanks to restrictive zoning policies that restrict the supply of new homes in the most desirable living areas.

Whereas housing stocks increased 40 percent in the 1950s, they rose only 14 percent in the 1990s. "Rising education levels and learning from other political battles, such as the civil rights movements, have made community members more adept at using courts and the press to battle against developments. And, as afforded by rising incomes there is a rising preference for living in low-density communities where crime rates can be lower and civic amenities better," said the study.

Although Chairman-designate Bernanke made all the right noises about inflation-fighting in his acceptance remarks, his record on the Fed's Board of Governors has been to advocate that interest rates remain as low as possible. Yet the tightrope he has to walk is becoming ever finer. Low interest rates mean a dollar falling in value, which helps our negative trade balance by making imports more expensive and exports cheaper. But it also endangers the 51 percent of total government debt now held by foreigners and governments, who do not like to see their dollar assets depreciating in value.

What does that mean for real estate? We believe that mortgage rates will also begin to come down next year, as the Fed's credit tightening begins to take effect. Bill Gross of PIMCO, our largest bond fund, believes that 2006 GDP growth could be as low as 2 percent. Mortgage rates just reached 6 percent for conforming 30-year fixed rates last week (now $400,000 for a single unit) with a 1-point origination fee (6.11 percent APR), the highest rate this year.