Popular Economics Weekly

WEEK OF APRIL 17, 2006—WILL FED POLICIES HURT REAL ESTATE?

With light sweet crude oil prices having just reached $75 per barrel, what will the Federal Reserve Governors do at their next May 10 meeting? Minutes of the March 27-28 Federal Open Market Committee meeting indicated that the Governors were beginning to worry they had gone too far in raising interest rates.

Most FOMC members thought the end of the tightening process was likely to be near and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy. However, members also recognized that in current circumstances, checking upside risks to inflation was important to sustaining good economic performance. The need for further policy firming would be determined by the implications of incoming information for future activity and inflation.

San Francisco's Fed President Janet Yellen went even further in advocating a pause to the rate hikes, in a subsequent speech quoted by the Wall Street Journal. While inflation risks are "tilted slightly to the upside," she was "increasingly concerned about the well-known long and variable lags in monetary policy—specifically, that delayed effects of our past policy actions might impact spending with greater force than expected," particularly in housing.

Real estate was much on the minds of the Fed Governors. In the housing market, for instance, some downshift from the rapid price increases and strong activity of recent years seemed to be underway, suggested the Governors, but the magnitude of the adjustment and its effects on household spending were hard to predict. It was also noted that an abrupt rise in long-term interest rates, reflecting, for example, a reversion of currently low term premiums to more typical levels, could weigh on both household and business spending.

However, the NAR's chief economist David Lereah thinks mortgage interest rates will remain favorable, in his April economic update to Realtors. "Economic growth and job creation are providing a favorable backdrop for the housing market, but rising interest rates have an offsetting effect," Lereah said. "Home sales will move up and down somewhat over the remainder of the year but stay at a high plateau, meaning this will be the third strongest year on record." This is even though he expects the 30-year fixed-rate mortgage to rise to 6.9 percent by the end of the year.

Lereah projects existing-home sales to drop 6.0 percent to 6.65 million this year from a record 7.08 million in 2005. New-home sales are likely fall 10.9 percent to 1.14 million from the record 1.28 million last year – both sectors would see the third best year following 2005 and 2004. Housing starts are forecast at 2.00 million in 2006, which is 3.2 percent below the 2.07 million in total starts last year.

HOUSING STARTS—March home construction fell to the lowest level in a year, down 7.8 percent to 1.96 million annual units when seasonally adjusted. This followed the latest National Association of Home Builders confidence index decline to 50, its lowest level in 3 years. It indicated that builders were split 50-50 on whether housing construction would continue to expand. But housing starts are 5.9 percent higher year-over-year, indicating there is still plenty of demand for new-homes.

The Fed Governors also believed inflation was still under control, in spite of the March rise in core CPI. "Underlying inflation was not in the process of moving higher," and "core consumer inflation was flat or even a bit lower by some measures," were some of the comments. They were no doubt referring to the latest Personal Consumption Expenditure index, which has increased just 1.7 percent year-over-year.

WHOLESALE & RETAIL INFLATION—March wholesale PPI inflation was up 0.5 percent due to higher gas prices, but its core rate without food and energy prices increased just 0.1 percent. The retail CPI rose 0.6 percent, however, and core rate was up 0.3 percent, indicating that this particular consumer index was showing higher inflation.

INDEX OF LEADING ECONOMIC INDICATORS—The Conference Board's index of future activity fell for the second month, and has been flat since November. Five of the ten indicators increased and five decreased, signifying why the index hasn't moved up or down. While consumer expectations (read sentiments) and stock prices rose slightly, for instance, the money supply and building permits shrank, thus canceling out the positive indicators. "The current behavior of the leading index suggests economic growth should continue moderately in the near term," said the press release, which is putting a positive spin on uncertain data.

The economy is obviously at a tipping point. The Federal Reserve is now worrying that the surging energy prices have put additional pressure on economic activity, on top of the huge private and public debt loads that must be serviced from current income and profits.

Why is real estate so vulnerable? A recent National Bureau of Economic Research (NBER) research paper found that "an unexpected future rise in real, long-term interest rates or a decline in economic growth, for example, could easily cause a fall in house prices."

This is because, "real, long-term interest rates are currently so low, our calculations suggest that housing costs are more sensitive to changes in real, long-term interest rates now than at any other time in the last 25 years."