Popular Economics Weekly

WEEK OF FEBRUARY 26, 2007--WILL FLIGHT TO QUALITY AID REAL ESTATE?

The Dow Industrials plunged 416 points yesterday, and existing-home sales rose 3 percent in January. While one month does not make a trend, does this signal that investors' uneasiness with corporate stocks (and so profits) may mean a rebound in housing? The Dow sell off was triggered by a sell off of Chinese stocks, spurred by a threat from China's central bank to restrict credit (and so economic growth) if China's banks didn't rein in their high risk lending.

But the sell off was undoubtedly reinforced by former Fed Chairman Greenspan's satellite remarks that the U.S. was nearing the end of this business profit cycle, and so ripe for the possibility of a recession by the end of 2007.

"When you get this far away from a recession (2001 was our last), invariably forces build up for the next recession, and indeed we are beginning to see that sign," Greenspan said in remarks to Hong Kong investors the day before.

Leaving aside Greenspan's reasons for such remarks at this time, a flight to quality has begun, meaning to what are perceived as safer investments. This is evidenced by the surge in bond prices that have brought AAA-rated 10-yr Treasury Bond yields down to 4.55 percent, as well as signs that the slowdown in real estate sales may be ending.

National Association of Realtors (NAR) chief economist David Lereah has been cautiously upbeat about prospects for this year.

"Home sales are leveling at historically high levels, and examination of data within the quarter shows home prices stabilizing toward the end (of Q4 2006). When we get the figures for this spring, I expect to see a discernable improvement in both sales and prices," he said in his most recent report.

Total existing-home sales including single-family and condos, were down 10.1 percent in the fourth quarter 2006 vs. Q4 2005, according to the NAR. But six states showed increases in sales over the previous year, including 14 metropolitan areas with double-digit annual increases.

Home sales continued to rise in several metropolitan areas according to Standard & Poor's national Case-Shiller price index, as well. The biggest gains were in Seattle (up 12.1 percent), Portland (up 9.9 percent), Charlotte, N.C. (up 6.7 percent).

The biggest total sales increases were in affordable states like Indiana, where existing-home sales rose 13.7 percent December to December 2006, Arkansas (up 11.1 percent), and Texas (up 6.2 percent).

Other activity this week signaled a slowing economy, though this didn't seem to faze Fed Chairman Ben Bernanke in more congressional testimony.

"Taking all the new data into account, there is really no material change in our expectations for the U.S. economy since I last reported to Congress a couple of weeks ago," Bernanke said. "We are looking for moderate growth in the U.S. economy going forward."

Industrial production has been shrinking for several months, new-home sales plunged due to winter weather, and the second estimate of fourth quarter Gross Domestic Product (GDP) growth was revised downward. Consumer sentiment is holding up, however, signaling that consumers still feel healthy.

GDP—The steep downward revision from a 3.5 to 2.2 percent growth rate surprised economists, in part because suppliers did not replenish depleted inventories as first thought. This is in spite of a 4.2 percent increase in consumer spending, and is another sign that inflation may be subsiding. The core PCE price index used to calculate the GDP rose just 1.9 percent in Q4, which is below the Fed's 2 percent upper inflation limit.

NEW-HOME SALES—Plunged 17 percent in January to 937,000 units when annualized, in part because of the colder weather. The sales rate is down just 10,000, though, from 1.01 million to 1.0 million units annualized over the last six months, vs. a 1.26 million unit rate in January 2005. This could mean this January was a one-time event, due to the weather, since sales over the past six months have leveled off.

We could be seeing a milder version of 2001, when real estate values began to rise in tandem with the fall in stock prices. Real estate values increased even more than stock values fell at that time. The result is that real estate now totals $19 trillion in valuations, while total stock market capitalization approximates the size of our Gross Domestic Product, or $13 trillion.

The current 6-month plus supply of unsold housing inventories means that prices will not rise as fast as in the past. The Harvard Center for Joint Housing Studies reports that 1.2 million new households per year will be formed over the next ten years, while 1.4 million new homes are currently started annually.