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Housing's Future

Economists are predicting a lukewarm economy in 2007. Much will depend on housing and the health of housing will depend on the Federal Reserve, which is still making noises about having to fight inflation. What inflation? Though wholesale inflation (the PPI) surged in December due to higher raw material prices, retail CPI prices were unchanged, while the Fed's preferred Personal Consumption Expenditure index is falling.

"The economy appears to be weathering the downturn in housing with limited collateral effects and inflation appears to be easing with the aid of lower energy prices, well-anchored inflation expectations, and competitive labor and product markets," said Fed Vice-Chair Donald Kohn. (But) "I believe it is still too early to relax our concerns about whether the run-up in prices pressures in the spring and summer of last year is truly unwinding and whether it is unwinding rapidly enough to forestall a pickup in inflation expectations."

The Fed is actually stalling, since its fed funds rate of 5.25 percent is still 0.5 percent above longer-term fixed rates and so squeezing bank and other credit lenders—who must lend at the lower, longer-term rates. This could seriously hurt housing this year, since the ARM indexes that now govern more than 40 percent of all mortgages are still rising in tandem with the fed funds rate.

The most dangerous index seems to be the 1-month LIBOR index (i.e., London Inter Bank Overseas Rate), which has soared to 5.32 percent at this writing. Add a 2.75 to 3.25 percent margin (in owner and investor properties, respectively) that is in the negatively-amortized, no-fee, stated income, low teaser rate Option ARMs, and we have already reached 8 percent in the underlying rate.

Why so dangerous? The difference between minimum payment and underlying interest rate of the Option ARM gets added to the mortgage principal. And when that amount reaches 115 percent of initial principal—it can be in 3 years—the payment jumps to the fully amortized underlying interest rate! That is the main reason for the surge in refinancings of late. Many just refinance into the same Option ARM as soon as the 1, 2, or 3 year prepayment penalty expires, though a much better so-called Hybrid ARM with underlying fixed rate is a better alternative.

December did see a pickup in consumer spending, a good jobs report, and better manufacturing and service sector activity. But the pickup in consumption late in the fourth quarter can be tied to two special factors: another incentive drive by the Big Three to sell cars, and to the drop in gasoline prices. So it might not be wise to extrapolate those trends into the future.

Consumer Spending

Consumer debt jumped 6.2 percent during the holidays, up \$12.3 billion, so that outstanding debt now totals \$2.39 trillion. This spurred a huge retail sales increase and so consumers still spend approximately 1 percent more than their incomes. Most—\$8.6 billion—was on their credit cards. Our government now owes \$8 trillion, so who can blame consumers for wanting to borrow more?

Unemployment

The jobless rate stayed at 4.5 percent and payrolls increased by larger than expected 167,000 workers. Job formation kept pace with a growing labor force for the first time since 2000. The only caveat is that job formation does not compare favorably with past recoveries on a year-over-year basis. Payroll jobs grew 1.4 percent in 2006, for instance, vs. 2.4 percent in 1996, which was 5 years into the prior recovery begun in 1991.

Many economists think that housing will not be so lucky this year. One reason is that residential construction and related jobs (i.e., contractors, real estate agents, and brokers) declined by 19,000 in 2006. Whereas, these sectors added 305,000 jobs in 2005.

UBS (United Bank of Switzerland) award-winning economist Maury Harris predicts a housing price decline of up to 10 percent in 2007. Why? The large amount of vacant housing for sale. Owners who occupy their homes are less likely to slash their asking price, because they can often afford to just sit tight until the market improves, explains Harris. But vacant units present a challenge to owners, who must pay the mortgage, insurance and utilities every month. The incentive to drop their price is large. And those sellers set the prices for everyone in a neighborhood.

And that could keep economic growth down. "The main reason continues to be the fallout on consumer wealth, incomes, and spending stemming from lower home prices," Harris said. This is particularly so if the Fed continues to maintain higher short-term rates and so takes money out of the economy. There may also be lags in the response of consumers to lower home prices, said Harris. Household wealth changes, and consumers don't react instantly to that change. But over time, if wealth is rising slower than income, consumption (and so home buying) could slow as well.

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