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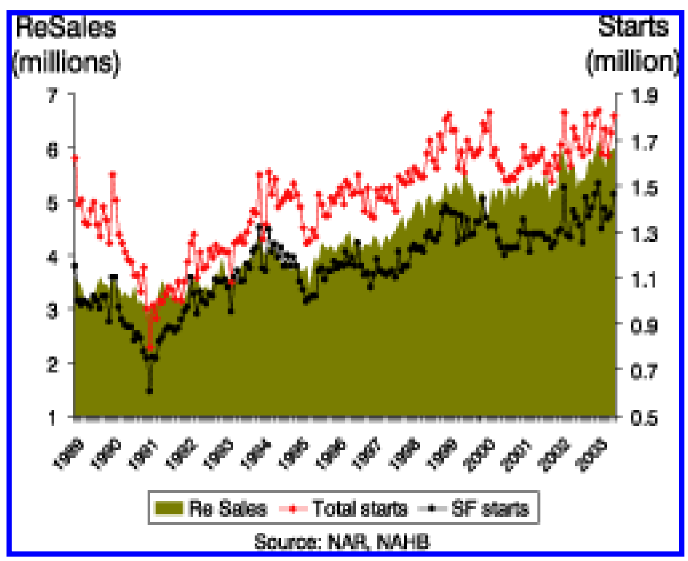
Economic Environment

Housing Market at Risk if the Economy Stumbles by Al Schuler

What do various economic indicators tell us about the forecast of the nation's housing market?

The U.S. economy is doing quite well considering the myriad of problems it has weathered in the past three years according to Irwin Kellner of the Dismal Scientist (www.economy.com/dismal/pro/article.asp?aid=2280). Consider the following: three-and-a-half years ago, the stock market technology bubble burst, wiping out six trillion dollars in "paper wealth" (about 60 percent of the value of one year's economic output or GDP); two years ago, the economy was in recession; the manufacturing sector has been shrinking for three consecutive years (2000 to 2003) with capacity utilization currently below 73 percent; there has been no net job creation in two years; and then add in geopolitical concerns like 9/11, the Iraq war, the SARS epidemic, and heightened terrorism concerns worldwide. Furthermore, some analysts, including the Fed, are concerned with the possibility of continuing disinflation (lower rate of inflation), or even deflation, an overall drop in real prices across the economy. Yet, the economy has managed to expand, nonstop, for six consecutive quarters, averaging a respectable 2.4 percent. What is remarkable is that this growth has occurred with one-third of the economy contracting or exhibiting no growth. Business investment (historically 12 to 15 percent of the economy) has been contracting, while net government spending (federal, state, municipal) has been flat.



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Consumer spending, historically two-thirds of the economy, has come to the rescue once again, supported in large part by the housing market. During the past six years, housing has played a key role by itself, and indirectly by supporting consumer spending. For example, we have had six consecutive years of record housing activity—single family starts, new home sales and the resale market (Figure 1). In addition, the remodeling market has been strong, although not quite as strong as the new and resale market. Consumer spending plus direct investment in housing account for over 70 percent of U.S. GDP, and during the past three years, almost all of GDP growth. In fact, if it were not for unwavering consumer spending, the U.S.

probably would be back in recession today. Housing has supported consumer spending in many ways—here are two. As home values increased, this allowed owners to “monetize” the equity in their homes—mortgage borrowing secured by homeowner equity. In fact, during 2002, “cash-out” refinancing pumped $97 billion from home equity back into the economy, with another $70 billion going toward paying off higher-cost second mortgages. Since March 2000, U.S. household’s stock portfolio value shrank by almost $6 trillion, but their real estate wealth rose $3 trillion—effectively cushioning that hit. Furthermore, housing equity accounts for a much larger share of the average American’s net worth. Therefore, the rise in home equity values had a bigger impact on confidence, further supporting spending.

		2001	2002	2003(F)	2004(F)	Outlook
Real GDP	%	0.3	2.4	2.2	3.5	improving
Real PDI*	%	1.8	4.3	3.0	2.3	weakening
CPI	%	2.8	1.6	2.6	2.0	decreasing
Unemployment	%	4.8	5.8	6.2	6.5	worsening
Real Bus. Invstmt	%	-5.2	-5.7	0.9	2.0	improving
Interest rates						
Fixed	%	7.0	6.6	5.6	6.1	increasing
ARM's	%	5.8	4.6	3.8	4.5	increasing
Prime	%	6.9	4.7	4.2	4.8	increasing

Table 1. Economic Outlook. Sources: Various (RISI, NAHB, APA and (www.economy.com/dismal/). [*PDI—personal disposable income]

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		2001	2002	2003(F)	2004(F)	Outlook
Total starts(SF&MF)	(000)	1,601	1,711	1,710	1,667	Flat/weakening
New SF sales	(000)	907	977	985	964	Flat/weakening
Existing home sales	(000)	5,282	5,598	5701	5537	Flat/weakening
Repair & Remodeling	Real % growth	-1.8	7.7	-0.4	-0.2	Flat/weakening
RFI*	%	0.3	3.9	4.7	1.1	Flat/weakening

Table 2. Housing Outlook. Sources: Various NAHB June 2003; RISI April 2003; NAR June 2003. [*RFI (residential fixed investment)—dollar value of construction put in place for new SF and MF structures, manufactured home shipments (HUD code), brokerage commissions on home sales and improvements to existing structures.

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HOUSING BUBBLE-NOT LIKELY

Of course, there are potential downside risks to the sustained housing boom—an overheated housing market that could collapse. With the collapse, overextended consumers (larger mortgage resulting from refinancing) would precipitate mortgage defaults thus putting additional downward pressure on house prices. However, widespread price declines are unlikely because home prices in most regions have increased in line with income growth and not through speculation as in Japan during the late ‘80s (The Joint Center for Housing Studies of Harvard University’s 2003 report, The State of the Nation’s Housing). Furthermore, the Harvard Center report pointed out that, historically, few localities experience the kind of concentrated job losses that are needed to precipitate severe home price deflation. What does this mean? In locations where house prices have outstripped income growth the most (the Bay area, NYC, Boston, Miami and Seattle where scarcity of developable land is a factor), we could see some home price erosion if the job market deteriorates further. But, even during recessions, most metropolitan regions do not experience the magnitude of job losses required to drive home prices down significantly. Also, when house prices deflate, they do so slowly as most home owners choose to stay put when prices soften. For example, the median national price of existing single family homes has not increased in the past six months (September 31, 2002 - March 31, 2003).

DEFLATION-POSSIBLE BUT UNLIKELY

Another issue is deflation, a period of continued decline in the overall level of prices. It is the opposite of inflation (consistently rising prices) and different from disinflation, which is a drop in inflation, or a decline in the rate by which prices are rising. See an excellent article on this subject by Alan Skrainka in the July 2003 Investment Perspective (www.edwardjones.com.) Not all deflation is bad. “Good deflation” (from productivity increases) occurred in the ‘50s, and this benefits consumers, while “bad deflation” (from weak demand) of the ‘30s variety is what worries the Fed. The Fed is concerned enough with deflation that they will keep interest rates low the rest of this year at least, just to “reflate” the U.S. economy. Housing will benefit from this strategy as long as the benefits (of low rates) outweigh the negative aspects of the weak job market, and so far, that has been the case. Most analysts discount deflation threats because, in addition to substantial liquidity already in the system, there are several things the Federal government can do to encourage spending. The Fed can also buy long Treasuries to lower long term interest rates, and impending tax cuts will put money in consumers’ pockets quickly (this is positive in that fiscal policy—taxes and government spending, and monetary policy are now in sync which was not the case in the ‘30s). However, the “U.S. can’t do it alone.” During the past six years, the U.S. has accounted for over half the world’s GDP growth, but that resulted in imbalances—an overvalued currency; dangerously high trade deficits; and a stock market bubble to name a few. We need help from Europe particularly in the form of lower interest rates to “reflate” one of the world’s largest economies (the combined GDP for the 17-country Euro region is about the same as the U.S. economy—about ten trillion U.S. dollars), and some help from China by unpegging the Yuan to the dollar. We’re now seeing evidence in the form of recent rate cuts that Europe's central bank (ECB) agrees that weak demand (and not inflation) is the relevant issue, and many analysts believe China will allow the Yuan to “float,” albeit within a narrow range, later this year (Jeffrey Garten, Business Week, July 21, 2003).

MAIN STREET VS. WALL STREET-TWO DIFFERENT ANIMALS

Longer term, positive demographics will keep housing strong for at least the rest of this decade (Schuler & Adair, Forest Products Journal, May 2003; August 2000, SBC Magazine) however, in the short term,affordability—jobs, income and mortgage rates—are the key factors. We don’t need to worry about mortgage rates with 44-year lows and inflation under control thanks to better productivity and overcapacity which reduces pricing power, so the only factor that could disrupt the housing market would be if the economy falls back into recession thereby exacerbating the negative employment and weakening income picture. I wouldn’t get overly concerned with the financial markets. Most of the key fundamentals impacting “main street” are different (at least the timing) from factors driving Wall Street, and from my vantage point, near term “main street” fundamentals (Table 1) are better than Wall Street fundamentals (corporate profit outlook). So, assuming we manage terrorism effectively, that leaves consumer spending and the job market as the only potential “bad guys.” Let’s address those issues.

ECONOMIC & HOUSING OUTLOOK

Much has already been done to encourage consumer spending which is needed to keep the job market from deteriorating further—Fed funds rate has been pushed to 44-year lows where real interest rates are now negative—a tremendous incentive to borrow and spend; taxes have been cut three times in three years; the U.S. dollar is down 15 to 20 percent or more against our major trading partners in past year—this makes our exports more competitive and imports more expensive thus strengthening corporate profits (and adds a needed dose of inflation); oil prices are lower, effectively freeing spending for other uses; and consumer and business confidence are improving, further stimulating spending and investment. So, there is lots of stimulus in the pipeline. As far as the job outlook goes, the Kellner article referenced previously argues the following—today's unemployment rate of 6.4 percent and edging upward—although well below past highs of 7.8 percent during the 1990-91 recession and 10.8 percent in the 1981-82 downturn—feels a lot worse. The main reasons: today, it is taking longer to find a job so people stay unemployed longer because many jobs are permanently lost; an increasing share of high paying white collar joblessness exists today; and many of today's unemployed are college graduates. The bottom line—today's jobless recovery is not as bad as past recessions, it just feels that way. With that said, current levels of excess capacity will be reduced only gradually, and that means the job market won't improve quickly. Furthermore, until economic growth exceeds trend (non-inflationary growth estimated to be about three percent), net job creation can't happen, and we won't see much improvement in the job market. For that reason, some analysts (including this one) are expecting the unemployment rate to worsen gradually through 2003 and maybe into 2004 before improving in the second half of 2004 or early 2005.

Below is a consensus outlook for the economy and housing. In essence, most analysts feel the worst is over, but there is no clear consensus as to the timing of the recovery (Table 1). The key to a recovery is a rebound in the business sector where weak capital spending has been the chief factor holding back the recovery to date. Although personal disposable income growth (PDI) will probably stay weak into 2004 (the impact of the lingering "jobless recovery"), low mortgage rates will help to keep housing affordable. There are just too many obstacles for much measurable economic improvement this year (including weak global growth), although the amount of liquidity in the system will keep consumer spending relatively healthy—this should keep the employment picture from deteriorating much further, and that should keep housing from stumbling (Table 2). Although the actual housing outlook is flat to weakening, we have to remember that we have seen six consecutive years of record residential fixed investment (RFI - Table 2). Consequently, there is little or no pent up demand as in past economic downturns, and the interest rate environment can't get any better. The message here is: "don't expect housing to lead the recovery this time." We're going to need more help from business investment and that won't happen until the "output gap" is reduced. The gap is the difference between what the economy can produce and what it is producing. Closing the gap means the economy has to grow in excess of trend or three percent, and that is what is needed to turn the employment picture positive. Although the economy will continue to struggle for a while longer, housing is expected to remain relatively buoyant. However, if the economy stumbles (e.g. another external shock), the job market will suffer, and this will eventually impact housing.

SIGNS OF IMPROVEMENT-WHAT TO LOOK FOR

1. Employment picture: we need to see payrolls expanding by about 150,000 per month for several months (www.bls.gov/news.release/pdf/empsit.pdf).
2. Business sector health: two good indicators are the ISM Index and investment spending. An index reading above 50 indicates expansion in the manufacturing sector (www.ism.ws/ISMReport/index.cfm). Investment spending has to start growing again after two years of contraction (www.bea.doc.gov/bea/newsrel/gdp103f.htm). Most of these indicators plus others are available at: (www.dallasfed.org/htm/data/data/us-charts.pdf).

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