THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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Some Upbeat News on Home Sales and Leading Indicators

Could today's two key reports on the economy be telling us the skies are finally starting to clear? Is the recession *really* in the process of bottoming out?

No. Keep the party hats in boxes and the Champaign in the cellar. It's just two economic releases (of which one is a rather minor one) and they tell us little about the future. The rise in both the existing home sales and leading economic indicators represent – at the very least --- a refreshing departure from an unending stream of awful macroeconomic news lately. However, we need to see December's trend sustained a few more months before we can begin to reassess the possibility that we are nearing a turning point in the economic cycle.

Existing Home Sales

Last year was a disastrous one for the home resale market. The industry managed to sell 4.91 million houses, condos and co-ops, the fewest in 11 years. All regions in the country saw sharp declines, with the steepest in the South (-16.6%), followed by the Northeast (-15.6%), Midwest (-14.9%), and West (-1.3%).

The biggest damage, however, was the collapse in home values, which helped trigger the greatest banking crises in 70 years. One of the most fundamental miscalculations

Wall Street investors and bankers made prior to 2007 was a bet that real estate prices in the US would never –ever --drop as much as it has. Their reasoning when you think about it seemed quite plausible. Baby boomers were nearing retirement age and eager to move to the Sunbelt. The children of baby boomers were forming new households, which would only add to overall demand for homes. At the same time, the supply of land was fixed. You can't create more of this stuff. Thus, with overall demand expected to climb and the availability of land limited, it made sense to expect home prices to climb in perpetuity. What followed set the stage for the mess we're in now. Homebuilders went on a massive construction spree (far beyond the pace of true demand), mortgage money was available to all regardless of one's credit or income history, and rates were historically cheap. It all turned into the greatest credit and building boom in US history.

But the party ended abruptly in 2007 and the industry has been in depression ever since. The median price of homes plunged another 15.3% in 2008 (based on December over December sales), the biggest annual drop ever recorded by the National Association of Realtors. It may well be the largest yearly fall since the Great Depression.

Let's break it down by type of home.

- Sales of existing single-family homes fell 1.4% in December from its year ago pace, with the median price tumbling 14.8% over the year.

- Condo and cop sales plunged 18.4% in 2008, and that led prices for these units to decline more than 18%.

It was a dismal year to be sure, but it ended on something of a high note. In the final month of the year, sales for all types of homes rose 6.5% to a 4.74 million-unit rate. True, that was still the second weakest monthly sales pace in 2008, but we'll take any upturn at this point. Of that total, single family home sales jumped 7% and condos and co-ops together saw a 2.1% increase.

The most important statistic of the day, however, was the inventory of unsold existing homes which continued to dwindle --- even with the addition of foreclosures!! The stock of unsold homes has now fallen for the fifth consecutive month and now stands at 3.67 million. That's the smallest since January 2007!! (By the way, it's been trending downward since peaking at 4.75 million in July.) The reduction in inventory and pick up in sales in December brought the inventory sales ratio down to a 9.3 months worth of supply, which turns out to be the lowest since June 2007. So we're edging a little closer to the 4 to 6 months range builders seek, and moving away from the 11.2 months peak of last year. This is good piece of news. We want to see a better balance emerge in the supply and demand for homes. If inventory levels continue to drop, it will set the stage for home prices to stabilize, which would be a huge relief to homeowners, bankers, the government, and any investor holding securities backed real estate assets.

Leading Economic Indicators (LEI)

Normally we don't get worked up when the Conference Board releases the LEI since it is based on economic indicators that have already been published. The LEI is simply a composite of 10 previously released indicators, each given different weights based on their predictive value. While the data underlying the LEI is not new, the index has been formulated to foreshadow future business activity and as such it can be noteworthy when it suddenly turns positive ---- especially against the current grim economic backdrop.

So we won't neglect it. The index of leading economic indicators unexpectedly rose 0.3% in December, the first upturn in six months. A large part of the increase was due to aggressive monetary easing by the Federal Reserve at a time when inflation is falling. That caused the inflation-adjusted money supply to jump. The yield curve also contributed positively to the index last month as the spread between the fed funds rate and the 10-year Treasury note yield increased. The steeper yield curve usually occurs when the economy picks up some steam. The problem is that the economy did the perverse in December, when GDP is believe to have contracted by a 5% rate. As a result, it's hard to get all worked up about last month's LEI increase.

Bottom line: After months of persistently bad news on the economy, we got a slight reprieve with today's unexpected improvement in existing home sales and LEI. Enjoy the moment. The good news may be ephemeral. There are a lot more macroeconomic stats to come out this week and they could (and probably will) cause the economic clouds to darken again.

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ECONOMIC FORECASTS

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