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ECONOMIC TALKING POINTS

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Economy & Housing: Withdrawal Pains Begin From a Tax Credit Fix

The question is a basic one for the US economy. Where do we go from here?

The economic recovery is about to reach its first anniversary and some will choose to mark the occasion by uncorking a pint-sized bottle of Champagne. But others warn that even a modest celebration is unwarranted because the economy's bounce back will be short-lived.

The double dippers argue the recovery was never sturdy to begin with, since it relied excessively on government handouts and a temporary build-up in private inventories. Both those are now fading, this group argues, and that will weaken the recovery's legs. With domestic unemployment still high and the economies of both Europe and China slowing, those wobbly legs will soon collapse and bring on another recession.

A marginally more optimistic scenario of what comes next is the "new normal." Here advocates doubt a recession is looming, but their outlook is not a particularly cheerful one either. They believe the US economy is doomed to five or more years of lackluster growth, perhaps 1% to 2.5% a year on average. Their argument is that it will take at least half a decade for the economy to reboot after a wrenching recession that did massive damage to the balance sheets of US banks. Suppressing growth further will be a cascade of new burdensome regulations and taxes from Washington. Put it all together and you're

left with a dismal sounding "growth recession," where the statistics claim the economy is growing, only most Americans won't feel it.

Finally, there is the more optimistic camp that believes this recovery is not only real but gradually acquiring more traction. As many of you know, we have been in this camp for more than a year and still support it. After all, never before have we seen interest rates so low for so long. Never before have we seen Washington pump so much money into the economy. Never before have so many nations work in concert to revive their economies and stabilize the global banking system. Rarely have we seen inflation so low, oil prices so stable, and companies sitting on so much cash!

And it is paying off. The private sector – not the government –is now driving this recovery. Want proof? When the economy grew at a 3% pace in the first quarter (a number that will probably hold tomorrow when the government releases its final estimate of growth that period), federal spending contributed just 0.1 percentage points to that figure. In fact, consumer spending alone added 2.4 percentage points, or 80% of the growth in the first three months. In the prior quarter, when GDP expanded by a more vigorous 5.6% rate, consumer and business spending accounted for virtually all of that increase. The federal contribution was an electron microscopic .01 percentage points.

And yet, there is admittedly one essential part of the recovery that has not yet come on line --- housing. It remains the weakest link in the economic chain, yet its comeback is vital to clinch the deal that this recovery is irreversible.

The latest set of housing reports has certainly given "double dippers" and those calling for a "new normal" lots of fresh ammo. Today, we got exceptionally grim news on new home sales, which tumbled 32.7% in May to a record low level of 300,000. These numbers were far worse than consensus expectations. All four major regions of the country saw sharp declines. The median price fell by nearly 10%. But before the double dippers or the new normal folks herald this as proof that they're on the right track, let's take a step back and understand the backdrop. News homes sales are computed by the number of contracts signed (not closings) and the May decline followed the rush to lock in deals by April to qualify for the home buying tax credit. So a sharp drop in new contracts was expected in May, if not one as bad as 300,000. Frankly, the slump in new home purchases may well last a few more months, since the tax credit succeeded in advancing sales that might otherwise have taken place over the summer.

But is the housing market about to suffer another cataclysmic downturn and further erode household wealth and the value of assets on bank balance sheets? No.

Do the housing stats condemn the economy to little or no economic growth the rest of the year? No.

Do today's numbers prove that future home sales remain completely dependent on government handouts? No.

Bear in mind that if you average out new home sales over the last three months, contracts signed came to a 378,300 rate--- which is more than the total for all of 2009. Moreover, even with the plunge in May contracts, the total inventory of unsold new homes still shrunk to the lowest level more than three decades. The continued decline in new home supplies puts builders in a better position once demand picks up, which should

begin again this winter. What we will have this summer is a temporary soft patch for an industry that is experiencing painful withdrawal from a tax credit fix that lasted more than a year.

A slightly better story emerged yesterday when we got existing home sales, which unlike new home purchases, is based on the number of closings. It fell 2.2% in May to a 5.66 million-unit rate. But the decline this time was not so much because of a fall-off in demand. According to the National Association of Realtors (NAR), nearly 200,000 homebuyers who signed a contract by the April deadline are having difficulty closing because of delays in mortgage processing. In other words, the demand is there and the contracts have been signed, only the deals are taking longer to close because of technical factors. Were it not for the delays in processing, sales in May would have been higher than that of April.

This leads to the next issue. If many of the 200,000 contracts that were signed by April 30th fail to close by the end of this month, they won't be eligible for the tax credit under current law. If so, an estimated 40% of the buyers may choose to cancel their purchase. There was a proposal by Senator Harry Reid to extend the tax credit closing deadline from June through September, which seems like a fair move. Give those who have contracted under deadline a little extra time to settle, since the closing delays are beyond their control. Unfortunately, Senate Democrats failed last week to get the necessary votes to pass legislation that included this provision. However, our research leads us to conclude this provision is not dead in Congress, and that it will ultimately pass and push the closing deadline to September 30th.

Having said that, even with the slight decline in sales last month, purchases of existing home sales still scored the second highest since last November, and stood 19.2% above the year ago level.

The median price of an existing home has risen for three consecutive months and now stands at $179,600, the most since last summer.

Sales of single family-homes, which has a track record of better gauging the housing market (because it condos and co-ops), declined 1.6% last month to a 4.98 million-unit rate. For the year, however, it was up 17.5%. Geographically, existing family home sales were up for the year in 18 of the 20 metropolitan communities, according to the NAR.

The median price of single-family homes rose 2.7% last month to $179,400, also the highest since last July. Prices were up in 16 out of the 20 areas studied compared with May 2009.

What will it take for housing to make a sustained comeback -– without relying on tax credits? For this we have to go back to fundamentals, which are employment conditions, mortgage rates and growth in the number of households. All show the dynamics for housing are moving in the right direction.

Employment conditions

There has been a lot of ink spilled lately on the disappointing jobs report for May. Private sector hiring slowed markedly that month according to preliminary numbers. Our expectation is that we'll see an upward revision in private payrolls that month when the release for June is out on July 2nd. What is encouraging is that companies have been expanding their payrolls every month this year. In addition, hours worked has been surging. Overtime is the highest in nearly two years. Real take home pay is accelerating. The latest ISM manufacturing and service employment indexes are both at multi-year highs. The Federal Reserve's latest Beige Book said the economy expanded in all 12 Federal Reserve districts for the first time in more than two years. According to the Labor Department, there are more job openings now than at anytime since November 2008.

Mortgage Rates

Both short and long-term rates remain at record low levels. We see little chance of that changing the rest of the year. Today's Federal Reserve meeting will bring no shift in interest rate policy. The statement itself will largely mirror those of previous meetings and keep the "extended period" phrase in place. With inflation in the US dormant and Europe in a crisis, the last thing the Fed want to do is create fresh uncertainties over monetary policy. The cost of longer term credit is also remarkably cheap. The average rate for a fixed 30-year mortgage was 4.75% last week, just four basis points above the record low 4.71% rate of last December. Best news of all, banks are beginning to make mortgages more available to homebuyers, according to the Federal Reserve.

Household Formation

As the numbers of households grow, so should demand for housing. For the last two years, home construction has been significantly below the rate of household formation and that can't be sustained. There are about 1 million new households formed each year, but the number of new homes built has been half that rate! The result is that the current inventory of new homes on the market is the lowest since 1970. We believe there is substantial pent-up demand for homes. When will it finally be unleashed?

Home buying will remain anemic through the summer as the expiration of the tax credit briefly depresses purchases. But housing should markedly improve later this year and in 2011 as rising employment, low mortgage rates, the growing number of households and more agreeable bank lending officers help to drive sales permanently higher.

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