THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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1. Home prices have surged. But is a bubble in the works?

2. Larry Summers at the Fed? Is the White House about to commit an unforced error?

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1. Home prices have surged. But is a bubble in the works?

We know an economy cannot possibly thrive if home prices are stagnant or falling. But at what point do home values accelerate so quickly, they actually poses a threat to the housing market and future economic growth? How do we know when a real estate bubble is in the works?

Today's release of the S&P/Case Shiller report showed home prices in the 20-cities index surged in May (year-over-year) by 12.2%, the fastest pace in more than 7 years. San Francisco led the charge with home values climbing 24.5%; Las Vegas was up 23.3%, Phoenix 20.6%, and Atlanta 20.1%.

Moreover, homes in cities like Dallas and Denver saw prices now breach their pre-recession peak, the first time this happen for any city in the index. Of the 20 cities tracked by Case Shiller, more than half have seen double-digit growth in values over the year. Similar sharp gains have been noted by the National Association of Realtors (NAR), which last reported

that the median price for existing homes sold in June shot up 13.5% in the year, the 7th straight month it recorded double digits hikes. (Mind you the June increase occurred even though sales slid 1.2% that month!!)

So is the hot real estate market showing symptoms of an incipient bubble?

The answer is not yet. For one, driving prices higher is not the result of reckless mortgage lending this time. The subprime mortgage market is still largely dormant and risk management practices at financial institutions have greatly improved.

What has been firing up residential real estate values is a combination of historically low mortgage rates thanks to the Federal Reserve, a scarcity of homes up for sale, and a recovering job market that has boosted demand. Our assessment is that market fundamentals will continue to remain positive at least through 2015.

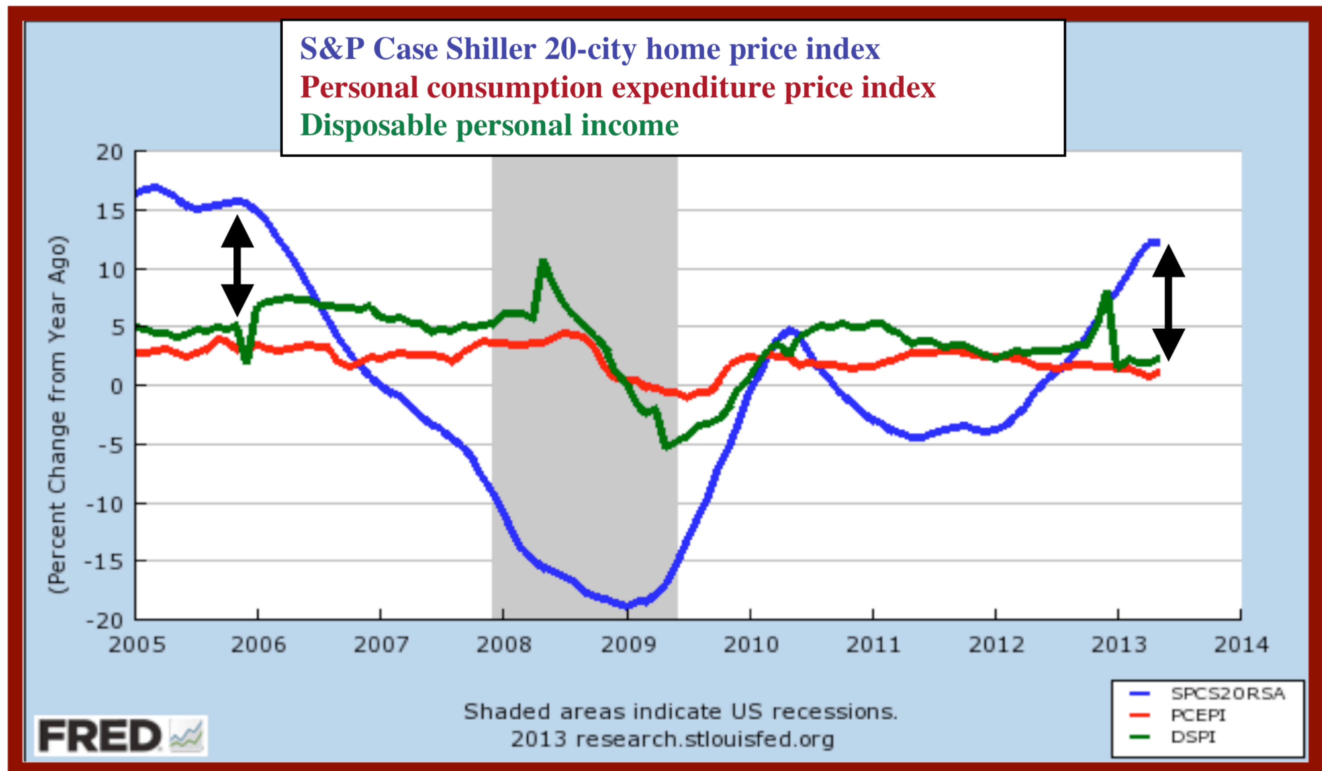
Having said that, we do believe the price increases seen lately are not sustainable. The next twelve months will likely see home values rise more slowly than the last twelve months. There are several reasons for this. First, mortgage rates will creep higher as the Fed slows the amount of new securities it purchases. By scaling back on QE, we expect to see 30 yr conventional mortgage rates climb into the 5% to 6% range by next year, after reaching a record low 3.31% last November.

Secondly, home prices are rising much faster than the general cost of living. For instance, the gap between the increase in the S&P Case Shiller home price index --- and the personal consumption price index is 11 percentage points. (The Case Shiller index is up 12.2%, while PCE inflation has increased 1% over the last 12 months.) That 11 percentage point spread was last seen in 2006, just as the real estate market began to topple.

Third, home prices are also climbing much faster than nominal personal income, and that will soon limit the number of Americans who will be able to afford buying a home. Disposable personal income is up just about 2% YOY, while both Case Shiller and the NAR are recording double-digit gains in home prices. (See chart below)

This spread between the climb in real estate values---and inflation or income cannot last much longer without raising the specter of a bubble.

Our expectation is that the pace of home prices increases will recede to single digits in the coming quarters--- ***unless*** consumer price inflation takes off (not an ideal outcome) or nominal wages finally climbs from its depressed levels (a far preferable adjustment).



2. Larry Summers at the Fed? Is the White House about to commit an unforced error?

The parlor game continues over who would succeed Ben Bernanke to head the Federal Reserve. Fun as it is to speculate, we have been getting calls from clients asking how the financial markets would react if the White House actually went ahead and nominated Larry Summers for that post.

Would a Summers appointment drive market rates higher and derail the housing comeback? Would it imperil the economic expansion?
Will a protracted approval process in Congress undermine investor confidence?
And why would the White House even dare to rattle markets in the first place by hinting at such a controversial candidate for the Fed, when the successor almost intuitively should be Janet Yellen?

In short, what is the White House thinking?

All the questions point to widespread concern that a Summers appointment introduces fresh risks to the financial and real economy. This is not to say Summers lacks the intellect for the job. He is justly recognized as a brilliant economist, with a blue chip resume. Moreover he is no stranger to Washington or to central bankers around the world. Yet few outside the White House seem enchanted with the idea of Summers running the Federal Reserve *at this highly delicate moment in the economic cycle*.

Why is that? For one, a blue chip resume is simply not enough to qualify someone for the top post of the world's most powerful financial institution. Remember, the Federal Reserve has evolved greatly over the years. So much so that simply being an outstanding economist is only one prerequisite for job of Fed chairman. Other vital qualities nowadays are the ability to communicate clearly with the public on Fed thinking and strategy, as well as a willingness to be a consensus builder on the Federal Open Market Committee. Many worry Summers lacks both these skills.

In addition, there is the likelihood of contentious hearings in Congress as both Democrats and Republicans pound Summers with questions over his zealous drive as Treasury Secretary to deregulate financial markets, along with his support to repeal Glass Steagall. Both these actions arguably helped bring on the worst recession since the Great Depression. Then there are the indelicate comments he made about women while President at Harvard. Finally, let's not forget there is also uncertainty about his thinking on the whole issue of quantitative easing, since he often ducks questions that relate to current Federal Reserve policy.

Our concern is that a Summers nomination could set off a period of excessive interest rate volatility, which would only add more stress to an economy still struggling to grow beyond a 1% pace.

So here's the bottom line. If the White House simply sought to launch a trial balloon to gauge the public's reaction to his appointment, it didn't gain much altitude before the critics took aim to bring it down. Again, it's not because Summers lacks the intellect or has some shocking new skeletons in his closet. It's because housing and jobs have only recently begun to turn around. Given the fiscal drag from sequestration and the fragility of the recovery, investors, business leaders, and even members on the FOMC believe it is in the best interest of the economy to have a seamless transition at the Fed.

We agree. Timing is everything. Now is not the time to rock the boat. A fluid hand off of the baton from Bernanke to Yellen makes most sense. Sticking the baton into the palm of Larry Summers ---at this critical juncture --- could unsettle capital markets and cause the economy to wobble. Would the White House really want to chance that?

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