THE ECONOMIC OUTLOOK GROUP

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DAILY ECONOMIC TALKING POINTS

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A Housing Recovery That Can Last

Clearly one of the challenges consumers, investors and business leaders confront these days is trying to make sense of what is happening in Washington and how it could impact the economy. Adding to the confusion is the fact there is little historical precedent for the fiscal maelstrom that has consumed the nation's capital. There is no experience we can look back to and see the implications once the Federal Reserve dials back on quantitative easing. Nor do we have much history on the consequences of a prolonged government shutdown, or the lack of agreement to raise the debt ceiling. Certainly not least of the unknowns is the extent to which the US might get dragged into the Syrian conflict. Indeed, the one sure piece of knowledge we have is that the geopolitical pot is now boiling furiously throughout the Middle East.

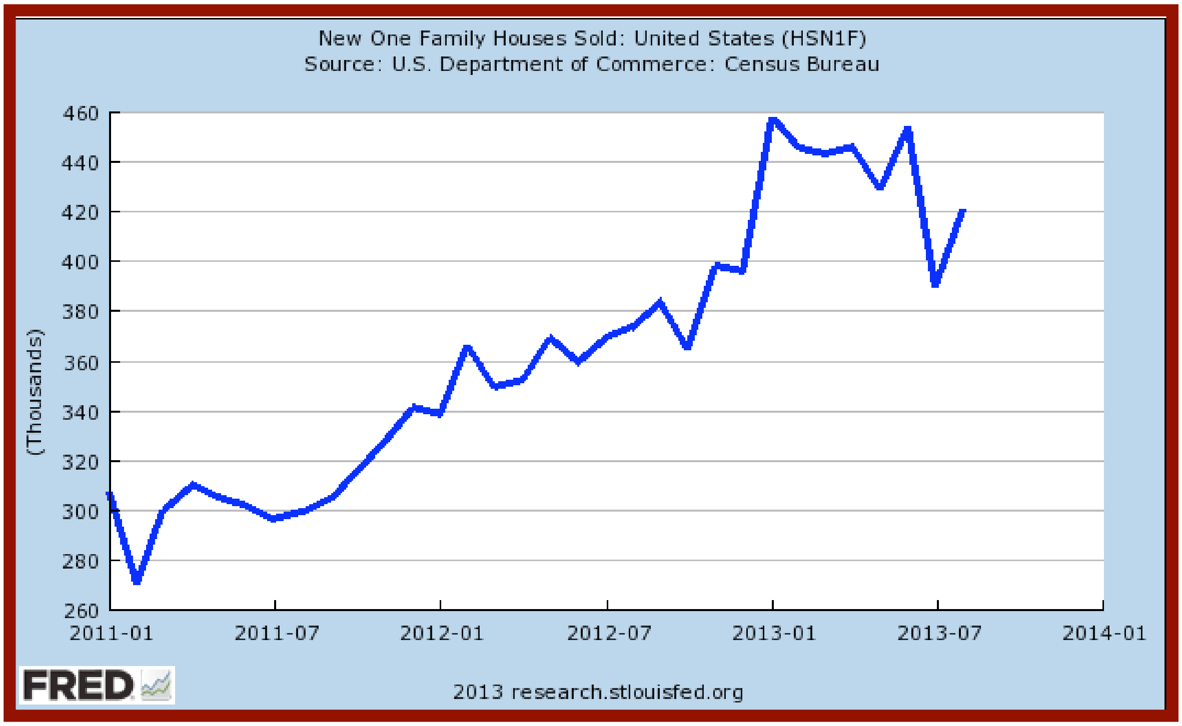
So how do you deal with such chaos? Simple, stay focused on the economic fundamentals since in the final analysis it is highly unlikely that Washington will imperil this economic expansion.

While most Americans may be exasperated, even infuriated, by the follies on Capital Hill, the fact remains the economy’s private sector is successfully gaining more traction. What is fueling growth is a genuine build-up in demand for goods and services.

We saw this again this week with the release of fresh economic data. Homebuyers did momentarily pull back in June and July when mortgage rates edged higher following comments by Ben Bernanke that the Fed might reduce monthly bond purchases later this year. The rise in borrowing costs forced more than a few potential buyers to place plans on hold while they crunched their numbers again to determine affordability and timing. As a result, contracts signed for new single-family homes slid the first half of the summer. But evidence is building this was just a brief sidestep.

Today's news showed homebuyers returned to builder showrooms in August and were prepared to buy again. Contracts to purchase new homes rose 7.9% last month, to a 421,000 annual rate. (Chart 1)

Chart 1

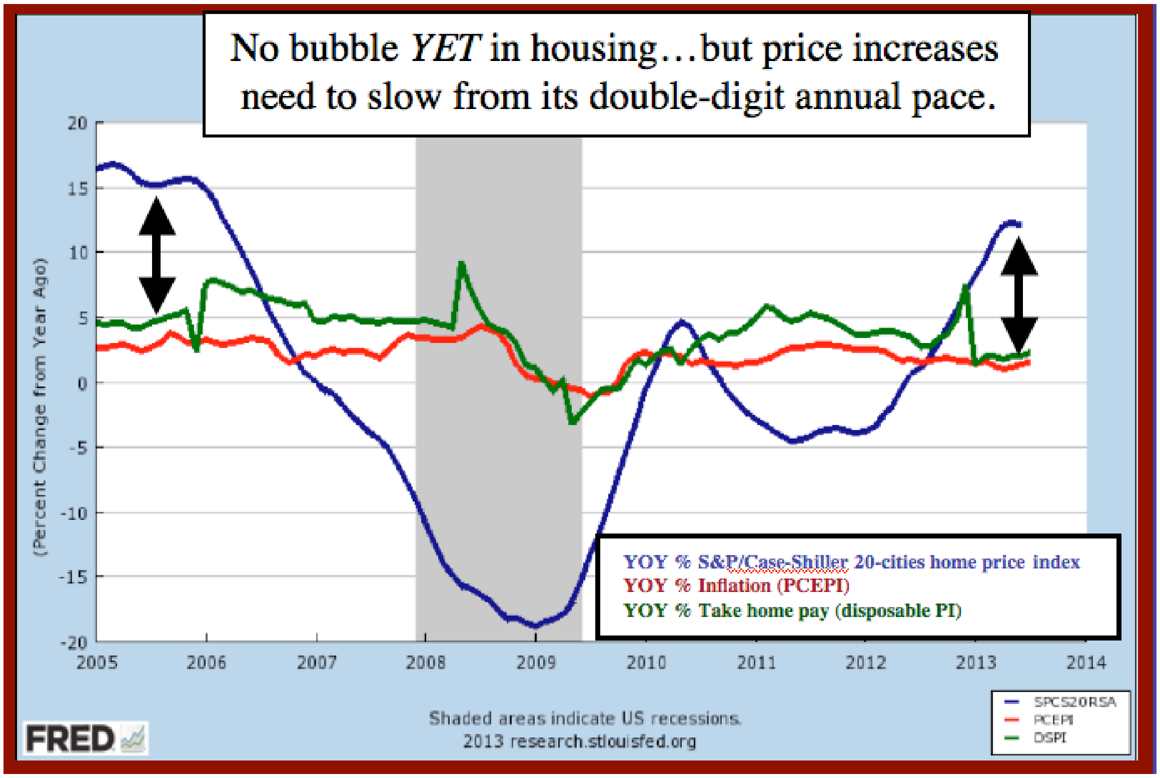


Moreover this upward trend is likely to continue. The National Association of Home Builders reported this month that traffic into their show rooms has now climbed to the highest in more than 7 years! We also got word that the number of mortgage applications filed to purchase a home rose by 7% last week, helped in large part by the realization that mortgage rates still remains at very affordable levels. The average rate on 30-year conventional mortgage actually slipped to 4.62%, from 4.75% a week earlier.

Let's be realistic, however. The cost of borrowing will undoubtedly increase in the coming months as the economy improves and the pace of home buying accelerates. But we are nowhere near the level where those rates can severely hurt home demand. For that to happen rates will need to cross into the 7% range---and we do not foresee that occurring anytime in the next 24 months.

One aspect of housing that is of some concern is the way prices have whip lashed back up. The S&P/Case Shiller index of home prices jumped 12.4% in July from its year ago level, the biggest leap in 7 years. This index has shown double-digit annual price increases in each of the last five months and some analysts have warned that a bubble may be near if that pace continues.

Chart 2



Frankly, that is not what worries me. Remember, there were more than 40 consecutive months of double-digit price increases between 2002 and 2006, so it is hard to get all worked up over just five months. Nevertheless, there is another disturbing trend that does bear close watching; it's the growing divergence between the rise in home prices and two other important metrics -- inflation and disposable personal income. The latter two have seen annual increases of just 1.5%, while homebuyers are seeing real estate prices surge by nearly 10 times faster. (Chart 2) The last time we saw a gap of such magnitude was in 2006. That's when the housing market finally collapsed and helped bring on Great Recession.

My expectation is that home price increases ***will*** slow in the coming months. Unlike the last decade when lenders recklessly handed out mortgages to virtually anyone who asked, banks and mortgage brokers now implement far tighter lending standards. By limiting the amount of leverage homebuyers can carry, the risk this time of a dangerous imbalance in the demand and supply for single-family houses is diminished and that ultimately should keep this housing recovery alive for at least another two to three years.

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