February 21st 2006

GFC ECONOMICS

DAILY COMMENTARY

BERNANKE WARNS ON HOUSING

The dichotomy between strong real economic data in the US and a deceleration in housing market activity was thrown into sharp relief last week. New Fed chief Ben Bernanke was keen to stress the delicate balancing act facing the FOMC in his first testimony to Congress since taking over at the helm. The relative outperformance of longer-dated Treasuries has been construed as evidence of the market's confidence in Mr Bernanke's judgement. By carrying on in much the same vein as Mr Greenspan, it would seem that the new Fed chairman has quickly established his policy credentials. However, an alternative interpretation might point to the inevitable risks associated with any attempt to deflate an asset bubble. Notwithstanding the housing starts report and the latest NAHB survey, mortgage demand is trailing off sharply. Consumer demand is undoubtedly strong, but the threat of a significant downturn in the housing market remains. Two or three more rate hikes from here may inflict considerable damage, not just to property, but also to credit spreads.

Higher Rates Will Slow Housing Further

Judging from last month's jump in housing starts, it might be hard to believe the real estate market is turning down at all. Building permits rose to a fresh high in January too, and with the NAHB survey stabilising for the second month running, some of the housing indicators were a little more encouraging last week. However, there were some extenuating circumstances behind January's record housing starts. In mitigation, the NAHB survey has been a reliable guide. The NAHB survey did start to turn down last summer, long before other property market indicators. That said, last week's sharp drop in the MBA mortgage applications index is hard to ignore. The composite index slipped to just 391.7 in the second week of February, and is now 26.0% down from last year's high-point. Of course, the index is quite erratic, but the eight-week trend is decisive in a number of respects. First, there have been six corrections or pauses in mortgage demand since the property bull market took off in earnest in early 2001. This is the largest by some margin. Second, the current decline in mortgage applications has continued even though mortgage rates peaked last November. That in itself suggests the equilibrium level for longer-dated Treasury yields is below current yields.

However, what constitutes an appropriate or equilibrium level of long-term rates can - and will often - diverge from reality. History has routinely shown that the destruction of asset bubbles can lead to a sharp and bigger than anticipated fall in borrowing costs. A record personal sector debt burden, the biggest post-war property bubble and a benign secular trend in core inflation underline the risks facing the US economy. But interest rates often overshoot in the final stages of an asset price cycle. The obvious reason for this tendency is the inevitable lags in play. The real economic data was actually quite strong for much of 2000, even though it was clear by early summer that the high-tech bubble had been punctured. Judging by the downturn in mortgage demand witnessed to date, there is a real risk that property prices could ease more quickly than hitherto expected.

In this respect, Ben Bernanke was right to emphasise during his testimony to Congress the need to focus on house prices in the coming months. The retail spending numbers were undoubtedly strong last month, and while the unseasonably warm weather may have played a

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part, the trend in the core numbers had been accelerating for some months. Excluding autos and gasoline shows that retail sales were rising by a 3m/3m annualised rate of just 5.3% last September. But since then, spending has been firming steadily, with the 3m/3m annualised rate reaching 9.2%. And with jobless claims falling sharply this year - notwithstanding last week's rise to 297,000 - the labour market is clearly underpinning the acceleration in consumer demand. February's payrolls are likely to confirm that the pace of hiring has strengthened significantly in recent months. All this matters if it helps to stabilise demand in the housing market. However, mortgage rates are trending higher again, and the strong real data may prove to be a lagged response to last year's exceptional gains in house prices. Conventional fixed deals are now costing 71 b.p. more than last year's 'mid-cycle low'. This interplay between housing and consumption will prove to be the critical dynamic that determines how far short rates have to climb.

The second obvious consideration will be any belated build-up in core price pressures, that also causes borrowing costs to somewhat overshoot. Mr Bernanke's warning "that output could overshoot its sustainable path" leading to "further upward pressure on inflation" was standard central banking patter. The explicit reference "that the economy could overheat and require a restrictive policy stance" was rather more worrying on one level. Most measures of wage pressures actually remain quite tame. Business sector unit labour costs were up just 0.9% y/y in Q4, the private employment cost index rose a modest 2.8% y/y, its lowest for nearly ten years. Average hourly earnings are accelerating, but the labour market participation rate remains historically low and well below the high-point witnessed in the dotcom era. Productivity gains over the past five years have significantly exceeded the second half of the 1990s, and yet there is much more slack in the labour market. According to the national accounts, corporate sector investment in business equipment is running at an all-time high - 9.6% of GDP - eclipsing the previous peak of 2000. The tendency towards overinvestment, a key feature of the dotcom era, has certainly not gone away. Against such a backdrop, the potential for further sizeable productivity improvements remains. Fundamentally, that suggests core inflation could fall back sharply should the housing bubble deflate more quickly than expected.

However, Mr Bernanke faces an unenviable challenge taking over at such a late stage in an asset price cycle. While the secular inflation trends may be comparatively benign, the risks of a sudden spike in the core CPI, triggering minor doubts over the Fed's policy credentials, cannot be entirely overlooked. Unless the new Fed chair had shown, or declared that he would act decisively if needed, the curve might steepen adversely and complicate the FOMC's attempts to engineer a soft landing in the housing market. Hawkish rhetoric need not imply an intent to tighten more aggressively, merely designed to act as an insurance against a couple of rogue inflation reports.

In this respect, there are a number of potential problem areas. Core service sector inflation is trending up, albeit gently. So long as durable prices continue to fall back, that should help to offset any further modest acceleration in services. Some of the omens are encouraging. The annual rate for imported consumer goods fell again in January, to 0.1%, down from a high last summer of 1.4%. But China is no longer providing the same cushion as before, with import prices for goods sourced from that country falling just 0.2% y/y in January, compared with a decline of 1.1% y/y when the renminbi was unitially revalued. The core PPI was up sharply in January too, and non-fuel raw materials climbed 1.6% m/m, the biggest monthly increase since August 2004. The core intermediate PPI has also been notably strong of late, something that should impact on the final PPI numbers. Many of these cost pressures have been apparent before, and successfully absorbed by companies within margins. There are few reasons to believe that will change materially over the coming year or so. However, at this late stage of an asset price cycle, a limited CPI spike cannot be entirely ruled out.