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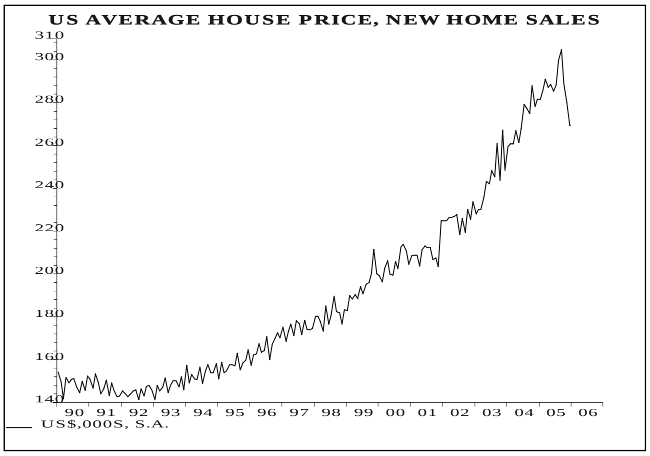
GFC ECONOMICS

DAILY COMMENTARY

RECAP ON US HOUSING BUBBLE AND TREASURIES

Notwithstanding Friday's trade numbers, last week was quiet data-wise, which provides an opportunity perhaps to recap on the fundamental tug of war facing the Treasury market. Some of the real economic data is turning out to be quite strong, particularly the labour market reports. By contrast, the housing data has been soft, and anecdotally, there are good reasons to believe the recent downturn in some property price indicators is a harbinger of more pronounced declines. It is tempting to argue that housing need not matter if the labour market is genuinely firming. Improved real incomes might offset any stall in property prices. But the real estate market could well prove very sensitive to any further rise in borrowing costs. It has also been critical in rebuilding balance sheets after the collapse of the dotcom bubble. Indeed, the net position of the personal sector is not nearly so favourable as it was at the top of the last asset bubble. Much depends on how the Treasury market responds to the prospect of a strong payroll report in February, and any short-term spike in inflation. The secular trend in core price pressures remains benign. But any significant sell-off in Treasuries from here could cause the economy to slow significantly later this year.



The Sensitivity of Asset Prices

The precise sensitivity of asset prices to any rise in borrowing costs is always subject to considerable uncertainty. Some still claim that it was not so much the rise in the Fed funds target to a high of 6.5% in May 2000 that hobbled dotcom shares, but the sudden downgrading in profit expectations for online retailer Amazon, that actually burst the bubble. However, the timing may have been coincidental. History would tend to show that the deflation of asset bubbles is usually presaged by some tightening of monetary policy. Furthermore, the rise in interest rates tends not to be that large. There are some notable exceptions. The Japanese discount rate went up from 2.5% to 6.0% before the Nikkei 225 tumbled in 1990. The collapse of UK property prices during the early 1990s was triggered by base rates of 15%. However, more recent examples tend to show that the scale of monetary tightening required has been far less pronounced. Indeed, the Nasdaq started to slide in the spring of 2000 with the Fed funds target still only at 6.0%, having risen by a mere 125 basis points from its November 1998 low. It was a similar story in the UK during 2003/04. Once again, short rates only had to climb 125 b.p. before the biggest post-war property bubble started to deflate.

The current US property bubble is following a similar pattern. Short rates have actually risen 350 b.p. from their 2003 low. By contrast, conventional fixed mortgage rates climbed just 84 b.p. last year from their lows in early July, before peaking towards the end of November. The significant rise in short rates matters, not just because of the indirect impact on mortgage rates, with banks scrambling to rebuild lending margins to compensate for the flatter yield curve. Home equity lending has slowed sharply too. The annual growth rate has dropped from a 2004 high of 46.5% to just 6.7%. But the 3-month and 6-month rates are already in negative territory (-1.8% and -2.1% respectively).

Nevertheless, the impact of such a modest rise in mortgage rates is instructive. The MBA mortgage applications index has continued to trend down, with the 8-week moving average dropping again to 445.2. Last week's warning from luxury homebuilder Toll Brothers that orders had fallen 29% in its first quarter was one possible signal of pending difficulties. Another

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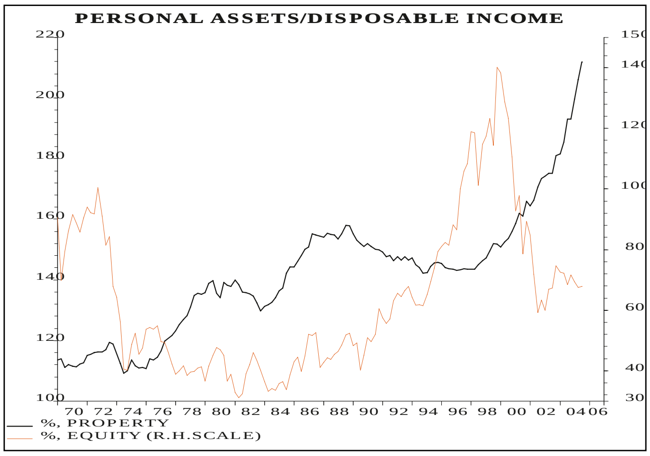
builder, Ryland Group, announced a smaller 4.7% drop in new orders for the final quarter of 2005. What matters in any asset bubble is not so much the drop in turnover, but the speed of any price adjustment. While both new and existing homes sales have fallen 7.4% and 10.2% respectively from their highs, these declines are not dramatic, yet. New home sales fell 44.2% during the two years from January 1989. Indeed, the reversal in the price indicators on this occasion has been more revealing and, historically, unusually large. Much depends on how much of the rise in inventories is due to speculators looking to sell. One aspect of the new home sales report has been particularly troubling. The number of completed new homes for sale has risen by 10.7% during the past year to December. But new homes for sale 'where construction has not yet started' - arguably the more speculative end of the market - has leapt 61.8% over the same period.

In this respect, the price data becomes critical, and as the chart on page 1 shows, the decline in the average value of new homes sold from its peak has been swift. The average price has fallen 10.2% from the September high. This is by far the biggest fall for any four-month period since current records began in 1975. The annual rate has already turned negative, dropping to -4.3%. Other price indicators were covered in detail in the January 30th commentary. Once again, the inherent volatility of the price data within both the new and existing home sales reports needs to be stressed. But these declines could nevertheless be a warning.

Of course, the underlying strength of consumer spending towards the end of 2005, and the prospect of a further improvement in real wage growth might help to soothe fears of a hard landing. The recent jobless claims data for one have been very encouraging. With last week's modest 4k rise, the 4-week moving average has fallen sharply to a new low of 276.5k. The speed of this decline has been impressive and increasingly hard to ignore. The payroll numbers have been turning up, and February could provide confirmation that the pace of hiring is accelerating.



All the same, these numbers need to be seen in the context of a housing boom that has been critical in helping the personal sector repair a balance sheet battered by the collapse of dotcom shares. The precise impact can be gauged from the chart on this page, which underlines the dramatic rise in personal sector assets held in property. The latest Federal Reserve flow of fund figures for Q3 2005 show that the ratio of property assets to disposable income has climbed 61.2% since Q1 2000, when the Nasdaq peaked. By contrast, the corresponding ratio for equity holdings has dropped 60.4% over the comparable period. However, that does not include the fallout from lower equity values on pensions. The ratio of pension fund reserves to disposable incomes has dropped 18.5% during this five and a half-year period. In short, the rise in property values has failed to offset the impact of the dotcom meltdown. The personal sector has suffered a net loss of total assets equal to 18.2% of disposable income. Given that total assets were still 630.9% of disposable income, the loss is not huge. But in the context of how fast property prices have risen during this period, it is still a troubling statistic, particularly when adjusted for the rise in liabilities. Net personal sector assets have shrunk by 46.9% of disposable income since the Nasdaq started to slide, falling from 551.3% to 504.4%. The property boom has singularly failed to offset the damage inflicted by the downturn in equity markets. The deterioration in net debt ratios since early 2000 implies that any further rise in borrowing costs - in response to another strong payroll report - could brake the economy sharply, and eventually force a swift policy reversal.