“Economic Forecasts for the Economy and Housing”
By Gary D. Halbert

The latest April report from the editors at The Bank Credit Analyst is consistent with what they have said in recent months. They believe that US economic growth will "decelerate" in the second half of the year, with growth averaging 3% or less in GDP. They do not, however, believe the US is headed into a recession, barring any major negative surprises.

BCA believes that the slowdown in the US economy will prompt the Fed to end its rate hiking cycle, perhaps at the June 28/29 meeting. They do not believe it will be necessary or wise for the Fed to raise rates above 5%. They believe the slowdown in the US economy will keep inflation in check.

Will home prices and real estate in general drop a lot more than is currently expected?

While BCA expects two to three quarters of slower growth in the US, they believe that the economies of Europe and Asia will continue to strengthen over the same period. For this reason and others, they expect the US dollar to resume its long-term downtrend.

BCA remains positive in its view of the equity markets, and believes investors should have slightly above-average holdings of stocks and/or equity mutual funds. While not raging bulls, the editors believe stocks could get a significant boost later this year when the Fed stops raising interest rates.

As for bonds, BCA feels that yields will come down when it becomes clear that the economy has slowed down. However, because the first quarter was a relatively strong one, they would not be surprised if bond yields move somewhat higher in the near-term. Thus, they recommend below average holdings of bonds for now.

As always, I highly recommend subscribing to The Bank Credit Analyst. Visit their website at www.bcaresearch.com.

Has the Housing Bubble Burst?

The much-ballyhooed slowdown in housing is now more than a prediction as February and March reports showed a national housing market that has, at the very least, peaked. While existing home sales increased 5.2% in February, new home sales dropped 10.5% in February, the largest monthly drop in nine years. Sales were also down in January.

Housing starts were down 7.9% in February when compared to January, but remember that January’s starts were abnormally high because of good weather. The more pertinent statistic was that February 2006 housing starts were down 13.4% from year-ago levels, definitely something to be concerned about.

The median sale price of new homes in the United States fell in February for the fourth consecutive month to $230,400. That was down 1.5% from January and 2.9% from year-ago levels.

The slowdown in sales pushed the inventory of unsold homes up to a record of 548,000 at the end of February. At the February sales pace, it would take 6.3 months to sell all of the homes on the market, up from 5.3 months in January. Analysts believe that the growing backlog of unsold homes will start to put more pressure on home sellers to reduce prices in the months ahead.

Making matters worse, it is not uncommon for builders to continue to crank out supply even after demand has peaked, especially given the development and permitting process required, so it is likely that the level of inventory backlog will continue to increase.

To say the least, demand for new housing is starting to wane. Bloomberg reports that the mortgage application index has plunged in recent weeks, with the four-week average back to levels not seen since November of 2003. The National Association of Homebuilders also reports that its monthly survey shows a marked drop in buyer traffic and sales expectations. It has also been reported that it is taking longer to sell homes, and there has been an increase in the number of people walking away from contracts to buy new homes.

The various reports noted above make it clear that the housing bubble has peaked. The question is, how bad will it get? One thing seems certain, that different parts of the country will be affected more seriously than others. But how bad the housing market gets in general is anyone's guess.

While the gloom-and-doom crowd is calling for a catastrophic drop in housing prices (don't they always), the editors at BCA see the housing market softening mildly in some areas and merely leveling off in others. They say: ***"A major drop in house prices is not in the cards, assuming we are correct that interest rates will soon peak."***

There are obvious effects that a softening in housing prices might bring about, not the least of which is a drop in consumer spending. However, you can see stories about this everywhere in the financial press. Instead, I'd like to point out several things I think we can take away from the latest housing statistics that might not make the other media outlets.

Thus, when housing becomes unaffordable, prices will stagnate, or even decline. That appears to be happening now.

First, is that the experts were right when they said housing prices could not continue to rise at double-digit levels forever. This reminds me of the late 1990s when some investors and analysts thought stocks would continue to deliver double-digit returns indefinitely.

The same goes for housing. No prices can continue to increase at double-digits forever without a commensurate gain in income, which has not occurred. Thus, when housing becomes unaffordable, prices will stagnate, or even decline. That appears to be happening now. As noted above, the median price for a new home is still $230,400. With mortgage rates increasing, fewer individuals will be able to afford houses at this price.

A second thought in regard to housing is to not expect the housing industry to wilt away quietly. Investors Business Daily recently reported how homebuilders are pulling out the stops in their efforts to woo buyers, including throwing in a variety of upgrades such as kitchen upgrades, landscaping and in some cases, even swimming pools.

These items don't necessarily show in the housing data, since the homebuilder supplies these perks, often at no additional cost. Thus, the homebuilder makes less on the house, but can still count it as a sale. Increasing the cost of homes sold, however, will have a definite effect on the bottom line of homebuilders, and this is already becoming evident. Several of the nationwide homebuilders have already issued profit warnings.

As noted above, BCA does not feel that the housing market is in for a bust, but rather a slowdown. Interestingly, the editors at BCA feel that a softening in housing prices could actually be the catalyst for a gradual rebuilding of the personal savings rate. You may ask how this could be, but BCA explains: *"There is no avoiding the fact that housing wealth has been largely used as a substitute for incomes, leading to a sharp drop in the saving rate. A cooling in housing should be the catalyst for a gradual rebuilding of the personal savings rate."*

There is no question that many homeowners have refinanced their mortgages (several times in many cases) and have used the equity in their homes to supplement their incomes and spending. This has resulted in what is commonly called a "negative savings rate."

BCA reasons that, as housing prices continue to soften, the ability to tap an increasing equity will go away. If so, the negative savings rate should also gradually go away. Taking it a step further, BCA suggests that if homeowners begin to worry about falling house prices, they will begin to save more of their incomes. We'll see.

Unfortunately, this potential for a rise in the savings rate will be at the cost of consumer spending, which makes up two-thirds of the US GDP. If consumer spending falls off too much as a result of a leveling off (or decrease) in home equity, the overall economy is likely to suffer. Just how much the economy will suffer and how hard GDP will be hit is anybody's guess. BCA continues to reject the gloom-and-doom scenario, staying with their expectation of a rather benign mid-cycle slowdown in the economy.

Conclusions: Risks Are High

The consensus is that the economy rebounded powerfully in the first quarter - up 4.6% (annual rate) according to the latest Wall Street Journal survey of economists. Yet if we look at the various economic reports we've seen over the last three months, we don't see such a rosy picture.

I will not be surprised if first quarter GDP is well below 4.6%. Inflation for the 12 months ended February was still above the Fed’s comfort zone. The Fed raised short-term rates for a 15th consecutive time in late March, and hinted that it's not done yet. A 16th consecutive hike is widely expected, and analysts are increasingly expecting a 17th hike on June 29. The question is, will the Fed go too far and push the economy into a recession? The gloom-and-doom crowd certainly thinks so.

Our friends at The Bank Credit Analyst, on the other hand, have a more benign outlook. They believe the economy is in for a mid-cycle correction, with slower growth over the next two to three quarters, but no recession. As growth slows, this should bring down inflation by enough to convince the Fed to end its rate hiking cycle, either after the May 10th FOMC meeting, or at the latest after the June 28/29 meeting. In 2007, BCA expects the economy to rebound strongly again.

The housing bubble has peaked, at least for now. Median home prices have fallen for the last four months, although not dramatically in most markets. The inventory of unsold homes has risen to more than a six-month supply, and is likely to rise more in the next month or two. How far home prices will continue to fall is anyone's guess, although BCA does not expect a huge drop in house prices. In any event, the era of refinancing homes every six months or so to cash-out ever increasing equity is coming to an end.

While the economic outlook is probably benign, with only a temporary dip in growth over the next six to nine months, there are plenty of “wild cards**”** at play. Will the Fed go too far in hiking rates? Will home prices and real estate in general drop a lot more than is currently expected? Will energy prices soar to new highs? Will consumers go into a funk and cut spending significantly? Will we drift into a recession? What about the war in Iraq?

As noted above, the editors at BCA believe we will avoid most of those things and a recession. They see another two to three quarters of slowing growth, with the economy improving again in 2007.

The stock markets seem to agree with them, and several of the major market indices have risen to new highs this year. That, too, would seem to suggest we are not headed for bad times just ahead, as promised by the doom-and-gloomers.

With that said, it is also clear that the risks are high, especially for the next six to nine months. As noted above, there are several things that could go wrong, and thereby dash consumer confidence and spending. While BCA believes it is not the most likely scenario, we cannot rule out a recession.

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