

Is a Housing/Real Estate Bust Looming?

By Gary D. Halbert

Perhaps the greatest risk to the US economy at this point is the housing/real estate market. At this point, it is clear that the housing bubble of recent years has peaked for this cycle, and further softening almost certainly lies ahead. Much the same is true of real estate in general in most parts of the country. The more common question on the minds of homeowners, real estate owners and investors is whether the housing/real estate markets are in for a major bust, or merely a cyclical retrenchment.

Obviously, this is a difficult question, but a major part of the answer lies in your overall economic outlook over the next year or two. For example, if it is your view that the US economy is going into a recession later this year (perhaps a severe one as the gloom-and-doom crowd promises, as always), then I think you would be correct to assume that home prices and real estate in general are headed into the tank (i.e. - much, much lower).

We need only look to the recent past for some examples. There have been two major housing down cycles in the last several decades - 1978 to 1982 and 1988 to 1992, both of which included economic recessions. In the 1978-1982 downturn, the combined total of new and existing home sales plunged by 55%, in large part due to the severe recession. In 1988-1992, when the recession was much milder, sales fell by 18%.

In the current cycle, sales of new and existing homes are down just under 9%. Comparatively speaking, home prices have not fallen nearly as much as in the last two down cycles. So, if you want to be bearish on home prices, maybe this is the statistic you should key on, in that by comparison to the previous two cycles, we could have a lot more to go on the downside.

On the other hand, if your outlook is more in line with that which I have suggested above (i.e. - no recession just ahead), then you should probably view the current softening in the housing/real estate market as more of a cyclical correction than a major bear market. That would be my suggestion.

But at the same time, we should not forget that the housing boom of the last decade has far eclipsed anything we've ever seen before. This has been possible due to a combination of the super-strong economy, more Americans working than ever before, falling interest/mortgage rates, creative financing, etc.

As to the latter - creative financing - many people who have purchased homes in the last several years will not be able to keep them. In fact, many people who should never have been able to qualify for mortgages have been defaulting on them for over a year now. According to data from the Fed and Freddie Mac, residential mortgage delinquency rates began to rise in the first half of 2005 and have accelerated steadily ever since. This trend will only get worse if interest rates continue to rise. The housing bears and the gloom-and-doom crowd are quick to point this out.

But what the housing bears fail to recognize is that while one segment of the homeowner population will be defaulting on their loans, vastly greater numbers of Americans are enjoying the financial rewards of the huge appreciation in value of their homes over the last decade or longer. Their personal balance sheets - including home equity - are typically stronger than ever. Secondly, as the economy slows down, interest rates should peak and turn at least modestly lower over the next six to 12 months.

The most likely scenario is that the current retrenchment in housing prices and sales is likely to last longer than in previous cycles, largely because the boom phase of the cycle was so long and overextended due to creative financing. As a result, it will take longer to work off the excesses of the past several years. Home prices are likely to soften further in most areas over the next year or so as the economy cools down for several more quarters. But barring any major surprises, we are not likely looking at prices falling by 30-50% as in some previous cycles.

BCA's Latest Analysis & Forecasts

For the last several months, The Bank Credit Analyst has been predicting that the US economy would slow down in the second half of the year, and that we would see several quarters of "below-trend" growth in GDP. Below-trend in this case means something less than a 3% annual growth rate in GDP. As noted below, we already have confirmation of this forecast since GDP softened to an annual growth rate of 2.5% in the second quarter. BCA continues to forecast another two to three quarters of below-trend growth lasting into 2007. Beyond the next two to three quarters, BCA expects the economy to rebound again.

BCA continues to maintain that a recession is not likely in the next year, barring some major surprise. The editors at BCA believe that as the economy shows clearer signs of slowing down, inflation will cool and interest rates will peak. As they have maintained all year, the editors at BCA do not believe the US economy is headed for a recession over the next year for a variety of underlying reasons and statistics, which are too detailed to go into here due to space limitations.

On a multi-year basis, BCA continues to believe the US remains in a long-term, technology-led economic "long-wave upturn," which began in the mid-1990s. As predicted by BCA back in the 1990s, this cycle has been highlighted by stronger than expected growth on the upside and shallower and shorter periods on the downside. BCA still maintains that we have at least several more years to go in this long-wave cycle before we hit a major recession and a potential financial crisis.

Are We Now Headed For a Recession?

While the latest GDP report was weaker than expected, and while some are concerned that we are now on our way to a new recession later this year, the broader economic data do not bear that out at this point. Despite the slowdown in GDP in the second quarter, consumer confidence has held steady over the last two months (June and July) as measured by the Consumer Confidence Index and the University of Michigan Consumer Sentiment Index. Remember that consumer spending makes up over two-thirds of GDP. While consumer spending was down somewhat in the second quarter, versus the first quarter, it is certainly still on a solid track.

Continuing on the consumer side, durable goods orders have risen respectably over the last two months. Retail sales rose slightly in June (latest data) and are up 5.9% over June 2005 as well. And the unemployment rate remained low in June at 4.6%.

On the manufacturing side, industrial production rose by a healthy 0.8% in June and was up 4.5% over the same period a year ago. Factory orders rose a solid 3.1% in June, the fourth monthly increase in the last five months. And capacity utilization (the factory operating rate) rose to 82.4% in June, up 2.1% over the same period last year.

These numbers and others do not suggest we are headed for a recession, at least anytime soon, barring some major surprise. If we average the growth rates in the first quarter and the second quarter, we get an annualized GDP of 4.05% for the first half of the year. That's considerably better than the economy did in all of 2005 when it grew by 3.2%, and even marginally better than 2004 when GDP grew by 3.9%. So for the time being, nothing suggests a recession is forthcoming.

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