

# US WEEKLY ECONOMIC UPDATE



March 24, 2006

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# US Economic and Investment Perspectives

## Extent of US Housing Downturn Will Depend on Fed Policy

The March survey of US homebuilders shows that the slowdown in the housing market is continuing—and that they expect it to last for some time. The overall homebuilder index fell one point to 55, the lowest level since April 2003. The largest component of the index is builder assessments of present sales, which also fell to early 2003 levels. This, coupled with a slowdown in traffic, has made builders less optimistic about sales for the next six months. The sharp drop in new-home sales for February confirms the weaker traffic and the lower volume that builders have been telegraphing in their reports.

Although the slowdown in demand is not yet evident in housing starts or prices, it probably will be soon. Historically, the homebuilders' index has correlated closely (0.70) with housing starts. Its decline suggests that housing starts should be running at about 1.9 million units annualized on a monthly basis rather than the 2.2 million average of January and February. Given that starts have run above underlying demand in the first two months of the year, creating more of an overhang of unsold new houses in the process, it would not surprise us if housing starts drop below the 1.9 million unit level in coming months. In addition, the combination of slower sales and excess inventory should put downward pressure on house prices.

Despite mounting pressures, we still expect a soft landing for the housing market, with house prices leveling off over the course of the year. But this depends a great deal on Federal Reserve policy. Indeed, a review of recent housing cycles both in the US and abroad suggests that their depth and duration depend on how high official rates are lifted in relation to overall economic growth.

In the early 1990s, faced with a cyclical rise in core inflation and a rise in inflation expectations, the Fed

was compelled to raise official rates well above the growth in nominal GDP in order to slow the economy and reverse the cyclical climb in consumer price inflation. Not surprising, the ongoing hike in official rates drained liquidity from the system and, in the process, curtailed activity in many cyclical industries such as housing. Although nationwide house prices showed no outright decline during any year, several major metropolitan areas saw prices fall relatively hard (off 10–15% from their highs) and remain at those levels for a series of years. Also, it wasn't until the mid-1990s, a span of seven to eight years, before prices in those areas rose above the previous cycle peak.

A similar script occurred in the UK and in Australia, where central banks raised official rates well above growth rates in nominal GDP to ease inflation pressures, thereby draining liquidity from the system. Not surprisingly, housing activity slumped in both countries and price gains disappeared quickly. In the UK, house prices actually fell for several years.

Interestingly, both countries have experienced a housing boom in recent years, with prices rising almost twice as fast as in the US. Yet the subsequent correction has been far less severe than it was in the early 1990s because central banks have not needed to tighten as much. Why? Core consumer price inflation—the main policy target of the central banks—has remained relatively low, if not below target, thereby limiting the need for more incremental tightening. As a result, the peak in official rates in the current cycle was far below that of the previous cycle and even below that of growth in nominal GDP. The latter is an important point because overall liquidity was not overly constrained, which lessened the blow to cyclical industries such as housing and eased the impact on real asset prices.

We expect the US housing cycle to follow a similar path. This is because core consumer price inflation,

the Fed's principal macro target, remains relatively tame, suggesting that the tightening cycle does not need to run much longer.

This month, Fed governor Donald Kohn said that the Fed's actions "will continue to be keyed to macroeconomic stability, not the stability of asset prices themselves." We interpret "macroeconomic stability" to mean stable core prices, not just for today but even more so in the future. When the Fed embarked on its tightening campaign in June 2004, core consumer prices were running 1.9% versus year-ago levels. By February 2006, core prices were up just 2.1%, an insignificant acceleration. Moreover, the Fed's forecast, released last month, shows that policymakers expect inflation to be back below the 2% level in 2007, although they did not disclose what level of official rates would be needed to get there. But with core inflation still tame and inflation expectations steady, the Fed might find it hard to justify another rate hike beyond the one that is widely anticipated at next week's meeting of the Federal Open Market Committee.

On the surface, the increase in February existing home sales seems to run counter to our view that the

housing market is slowing. Sales rose 5.2% to 6.91 million units last month. However, the Mortgage Bankers purchase index has continued to decline, which suggests that the increase in February sales is more a blip than the start of a new trend. At the same time, the inventory and sales price data lend support to our view. Inventories rose to 3.03 million units, not far from the record level of 3.04 million units reached in 1986, and the month's supply is up sharply from year-ago levels. Meanwhile, median and average prices for existing homes continue to inch lower; in February, both stood roughly 5% below the peak reached in August 2005.

Nonetheless, if the Fed is nearing the finish line, as we believe, the current slowdown in the house-price cycle should prove shallower and shorter than it was in the 1990s. But for that to occur, the Fed will need to follow the example of the UK and Australian central banks, which stopped tightening once core inflation pressures seemed benign.

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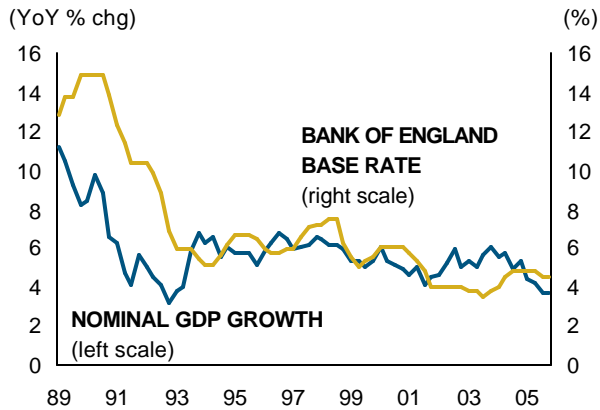
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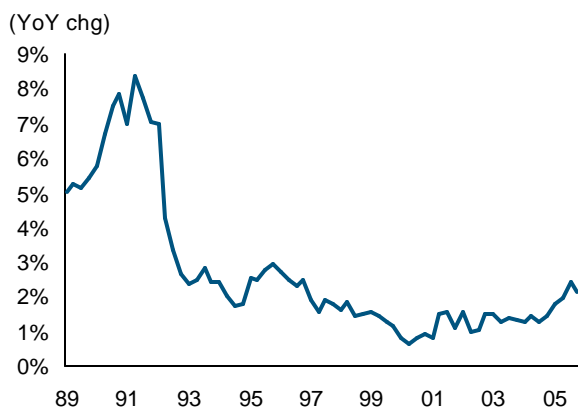
## Display 1: Asset Price Cycle Is Highly Dependent on the Official Rate Cycle

United Kingdom

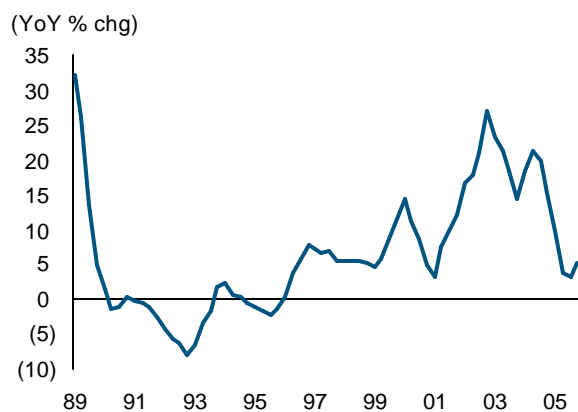
### Economic Growth and Official Rates



### Growth of Consumer Price Index



### Growth of House Prices Index



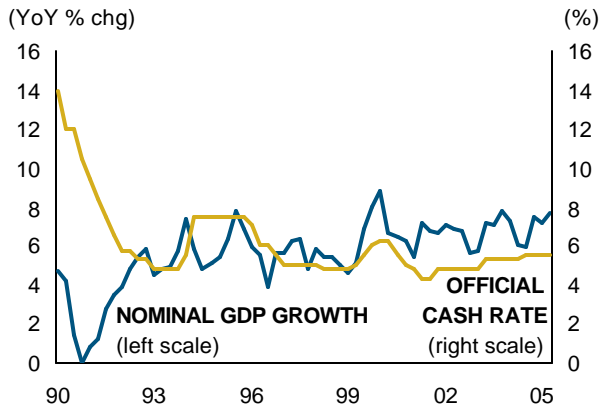
Source: Haver Analytics 3/24/06

*The official rate cycle has a very powerful influence on asset-price cycles. In the UK, relatively tame core consumer price inflation has limited the need for more aggressive tightening, which has led to a longer and more robust real asset-price cycle.*

**Display 2: Asset Price Cycle Is Highly Dependent on the Official Rate Cycle**

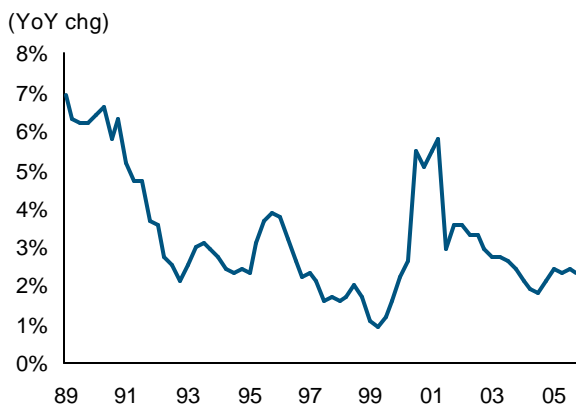
Australia

**Economic Growth and Official Rates**

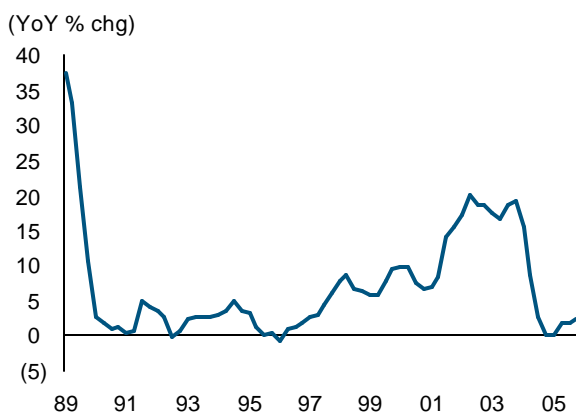


*In Australia, the real asset-price cycle has followed the same path as the UK—primarily because Australia’s official rate cycle has also been more benign than in the early 1990s.*

**Growth of Core Consumer Price Index**



**Growth of House Prices Index**

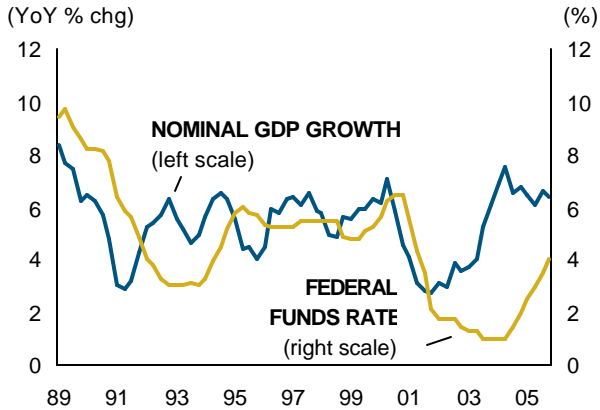


Source: Haver Analytics 3/24/06

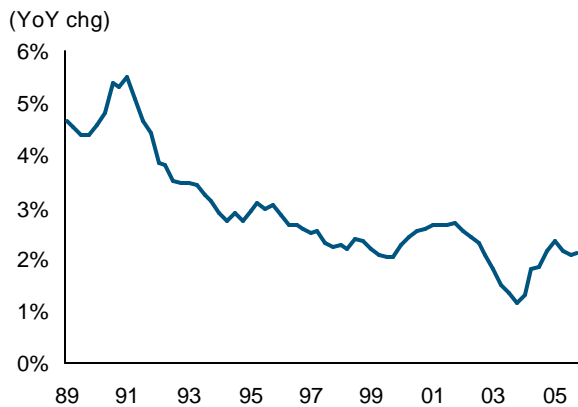
**Display 3: Asset Price Cycle Is Highly Dependent on the Official Rate Cycle**

United States

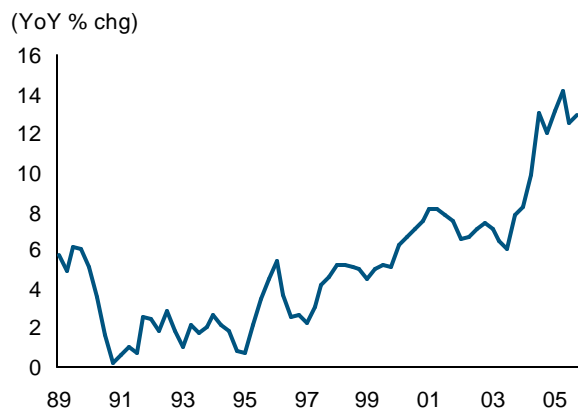
**Economic Growth and Official Rates**



**Growth of Core Consumer Price Index**



**Growth of House Prices Index**



Source: Haver Analytics 3/24/06

***The US real asset-price cycle is about one year behind that of the UK and Australia, but it should follow much the same path.***

***Importantly, house prices should not collapse as long as the official rate cycle is benign.***