GLOBAL ECONOMIC
RESEARCH

US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

Housing Should Continue to Drive US Spending

In recent years, the US housing market has been a significant driver of US economic growth. In fact, our recent research suggests that it has contributed more than many analysts—including us—had hitherto thought. Current evidence suggests that this powerful driver will continue in the months ahead—contrary to expectations that the housing market is about to peak.

Recent figures are compelling. For instance, annual dollar sales transactions are running just under $2 trillion—double what they were five years ago. This incredible growth has meant that homes have become a source of liquidity and a huge generator of cash and capital gains. Based on our analysis, cash-out financings, equity take-outs and realized capital gains on the sale of residential properties totaled $640 billion in 2004, more than double the amount withdrawn five years ago.

Much of this extra cash flow, especially realized capital gains, appears to have been re-invested in the housing market. Surveys have found that individuals use about 85% of their capital gains from the sale of a house to help pay for their next home purchase. That still leaves a lot of cash in consumer pockets: The remaining 15% of nearly $400 billion in capital gains is almost $60 billion. In addition, consumers also had at their disposal all of their home-equity extractions from last year's cash financing and home-equity loans.

This goes a long way toward explaining the fast gains in consumer spending and the decline in personal savings over the past few years. Moreover, we see no reason why this source of spending should dry up anytime soon. Indeed, we estimate that the housing market will generate as much extra cash flow in 2005 as it did in 2004. Most of these gains will likely come from capital gains, given the elevated level of home sales and the relatively strong price appreciation of the past several years.

History suggests that it would take a large and sustained rise in interest rates, along with a sharp and sudden deterioration in the labor markets, to cool the housing market anytime soon. As we noted last week, the Federal Reserve is well aware of the strength in the housing market; indeed, concern about housing price inflation remains one reason that the central bank will likely continue to tighten. However, we do not anticipate that the Fed will accelerate its pace anytime soon—thereby undermining the strength on the housing market—because doing so might hurt other parts of the economy.

Explosive Growth in Housing

The rise in house sales and prices over the past several years has been stunning. Total sales for new and existing units totaled 7.5 million units annualized in March, up from 5.5 million units five years ago and 4.1 million units ten years ago. The average price for existing homes stood just under $250,000 in March, up from $175,000 in 2000 and $140,000 in 1995. Prices for new homes were slightly higher, averaging $288,000 in March, up from $200,000 five years ago and $160,000 ten years ago (**Display 1**).

Taken together, the explosive growth in sales and prices has pushed residential sales transactions to about $160 billion per month, or just under $2 trillion for the year—double the total in 2000 and nearly four times the 1995 total (**Display 2**). To put this in perspective, monthly retail sales—which capture household spending on all durable and non-durable goods—runs around $340 billion per month. So housing transactions now are almost equal to half of retail sales transactions. In 1995, housing transactions were just one-fourth of retail sales transactions.

Every existing sales transaction has the potential to unlock capital gains in individual homes. To estimate the scale of capital gains that have been realized over the past several years, we multiplied the sales of existing homes by the appreciation of home prices over the average length of time the average family remains in the same residence. For this exercise, we assumed a five-year holding period (a longer period would have made the gains even larger). Based on the current pace of unit sales and price appreciation, we estimate that realized capital gains totaled just under $400 billion in 2004 (**Display 3**). Importantly, almost all of the capital gains are tax free today. This is because the current tax law requires individuals to report only the capital gains that exceed the allowed limit—$250,000 for a single person and $500,000 for a married couple.

Many other households have been able to tap equity in their home without moving: Home equity loans and lines of credit increased by about $100 billion in 2004. Also, Freddie Mac estimated that the total amount of home equity cashed out at the time of refinancing was about $140 billion in 2004. Hence, our estimate that total cash taken out of housing added up to $640 billion last year.

This year, the amount of cash-out money tied to refinancing should fall since the number of mortgages that would be economic to refinance is now a lot smaller. Yet realized capital gains, as shown by the volume of sales and price appreciation, are currently accumulating at a pace that suggests they will exceed last year's gain by a large margin. Thus, we would not be surprised if consumers once again garner considerable cash flow from the sale of their homes—cash that will be available for further spending and investing.

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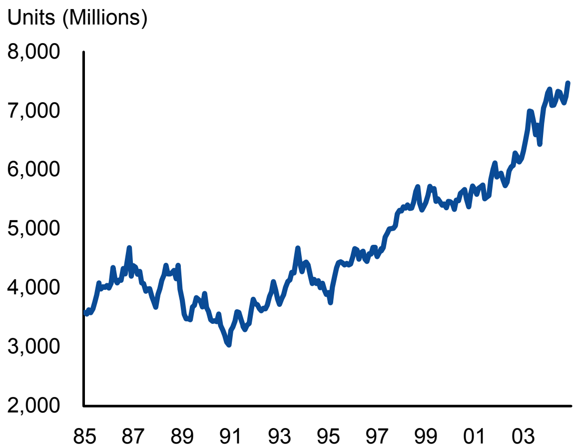
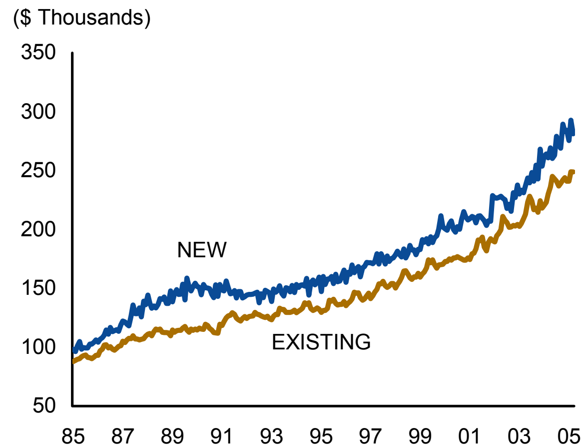
Display 1: Housing Boom; Both Unit Sales and Prices Are Up Sharply over the Past Several Years

Total Home Sales



Source: Census Bureau, Haver Analytics and National Association of Realtors

Average Price of New and Existing Homes

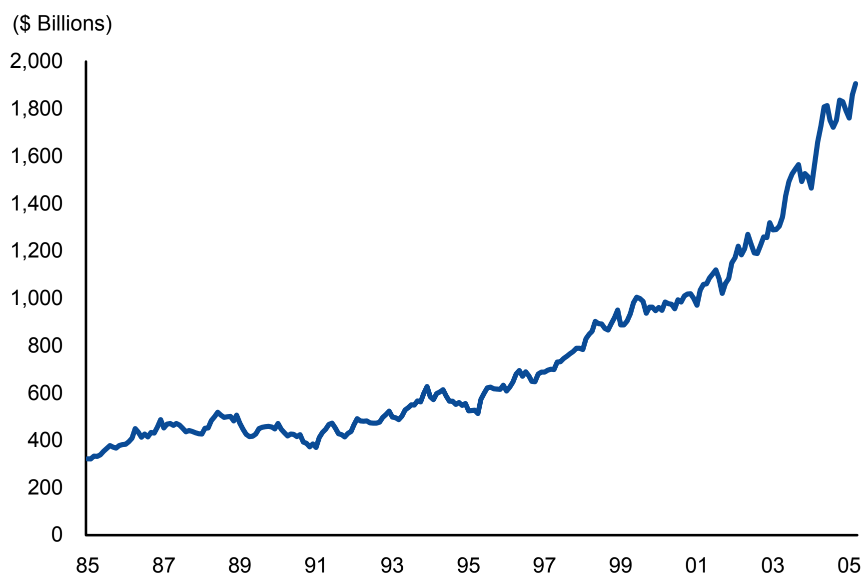


Source: Census Bureau and Alliance Capital Fixed Income estimates

The housing market has been booming for a decade, with total sales and prices now double what they were 10 years ago.

ACM FUNDS

Display 2: Real-Estate Transactions (Dollar Sales Volume; Annual Rate)

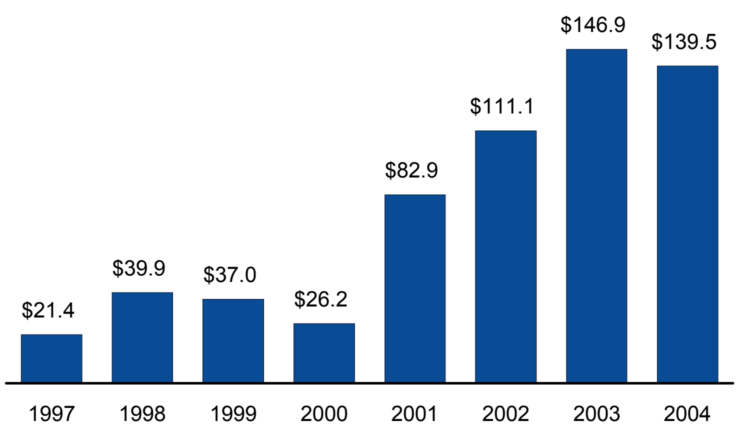


Source:Census Bureau, Haver Analytics, Naitonal Association of Realtors and Alliance Capital Fixed Income estimates

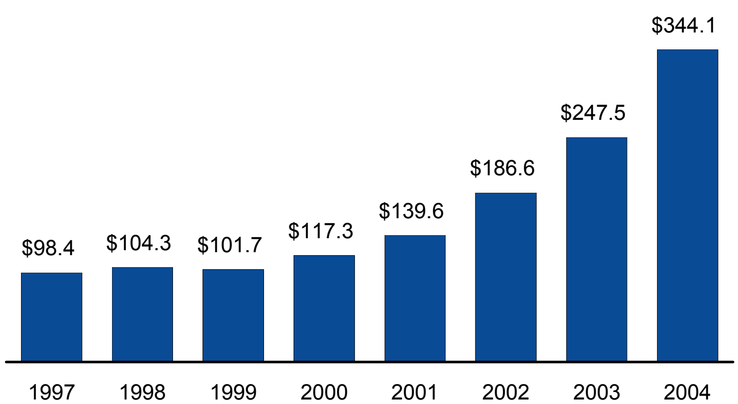
In dollar terms, total housing transactions are averaging around $2 trillion—double that of five years ago.

Display 3: The Extraction of Equity from Housing Is Huge

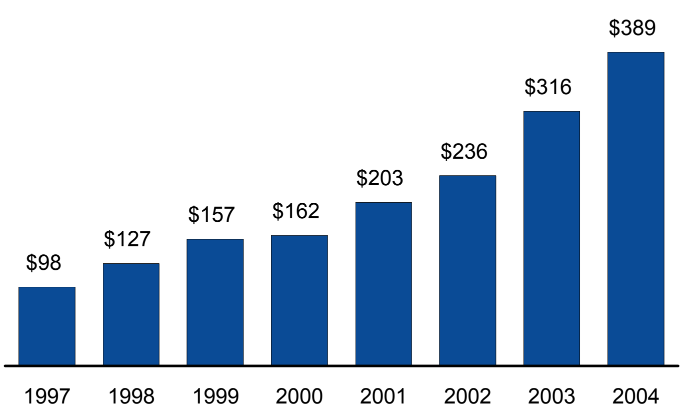
Estimated Cash-Out Financings ($ Billions)



Home Equity Loans ($ Billions)



Estimated Capital Gains from Housing ($ Billions)



Source:Department of the Treasury, Federal Home Loan Mortgage Corporation, Haver Analytics and Alliance Capital Fixed Income

We estimate that homeowners extracted a total of $640 billion in equity from their homes in 2004—a figure which should remain robust this year. We expect most of this value to be concentrated in realized capital gains, which could total $500 billion in 2005.