

# US WEEKLY ECONOMIC UPDATE



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# US Economic and Investment Perspectives

## US Housing: Are Expectations “Substantially Distorted?”

The US Federal Reserve raised the federal funds rate another 25 basis points to 3% on Tuesday, the eighth consecutive hike since June 2004. The statement that followed the Fed meeting also suggests there will be more increases to come.

While this was no surprise, there appears to be a broad misperception as to what will drive future rate hikes and the magnitude of the increases. Many analysts believe policymakers are simply trying to limit the rise in inflation, given its rise in recent months. However, we believe they are increasingly concerned about the gap between spending and saving and the rise in real asset prices, notably in the heated housing market.

In a speech in late April titled “Imbalances in the US Economy”, Federal Reserve Governor Donald Kohn warned of worrisome underlying issues in an otherwise healthy US economy. He specifically noted the rising current-account imbalance, the decline in household savings, historically low real and nominal interest rates and the surge in residential real-estate prices. He questioned, moreover, whether the spending imbalances, low rates and asset-price increases can continue without triggering adverse macroeconomic consequences.

“Are expectations substantially distorted?” Governor Kohn asked, referring to low nominal Treasury yields and risk premiums on private securities, fast price increases in real estate and the weakening dollar. But he singled out housing as a source of particular concern. “People should now be aware of the risks in the real estate market.”

In a fundamental sense, Kohn’s question recalls the infamous December 1996 comment by Federal Reserve Chairman Alan Greenspan: “How do we know when irrational exuberance has unduly lifted asset values?” The chairman was focusing on equity asset prices, Kohn on real asset prices.

Kohn’s speech continued: “There is [a] role that monetary policy plays in reacting to these imbalances and their inevitable unwinding...By increasing the return to saving and by dampening upward momentum in housing prices, rising interest rates should induce an increase in the personal savings rate, and thereby lessen one of the significant imbalances we have noted.”

But this begs the key question: At what level will interest rates trigger a rise in saving and a slowdown in house-price inflation? It appears they will have to go a lot higher to encourage greater savings, and much higher to slow housing prices. For instance, interest rates for certificates of deposit and passbook savings remain low, nominally at about 3%. At the same time, house-price inflation is averaging 8% to 10% nationwide, and people expect it to continue given the strong growth in both home sales and real-estate lending.

There is other evidence the housing market is red-hot. A recent study by the Federal Deposit Insurance Corporation focused on historical housing-price booms, which it defined as an increase of at least 30%, inflation-adjusted, in home prices over three years. From 1978 to 1998, fifty-four metropolitan areas (out of a total sample of 361 areas) experienced a boom at some point during this 20-year period. But in 2003, there were 33 areas and in 2004 that number rose to 55—one more than the entire 20 year period. Speculative activity—measured by the percent of mortgages taken out by investors rather than resident owners—also rose, especially in areas with fast housing-price increases.

The challenge facing policy makers is finding a “neutral” interest rate that will spur savings while cooling housing prices. That is a daunting task: To effectively cool the housing market, rates will likely have to be much higher—higher, probably, than is appropriate for the general economy. But this is a risk they may feel compelled to take, given the downside of ignoring escalating real asset prices—jeopardizing their longer-term objective of price and economic stability.

We are not suggesting that Kohn's comments indicate policymakers are directly targeting house-price inflation. It does, however, appear to be playing a key role in their interest-rate policy decisions. In our view, this suggests a growing risk that the Federal Reserve will be obliged to push rates higher than generally anticipated. In this respect, we believe the speech is a wake-up call, alerting the market that policymakers believe that current

spending imbalances and asset-price trends are unsustainable.

This can mean just one thing, in our view: Monetary policy will play a role in any plan to unwind these imbalances.

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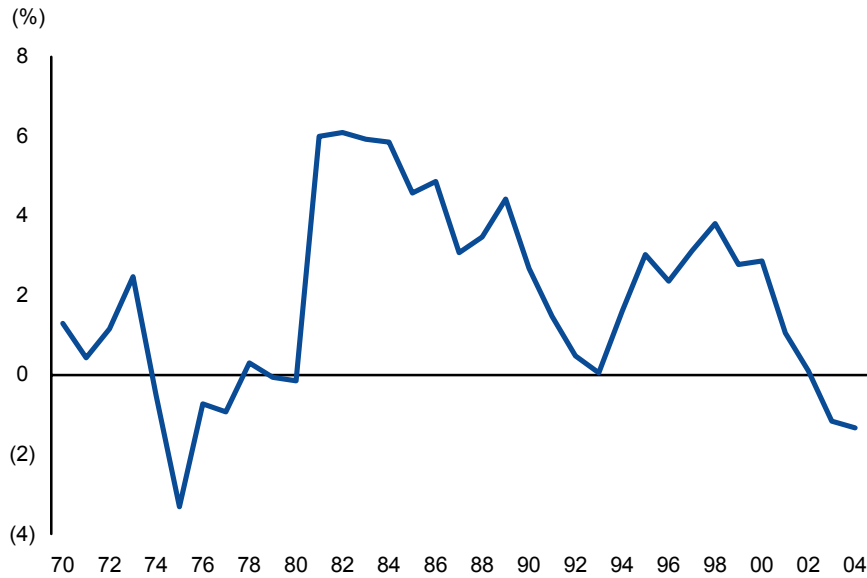
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## Display 1: Real Interest Rates Are Too Low

### Real Annual Federal Funds Rate

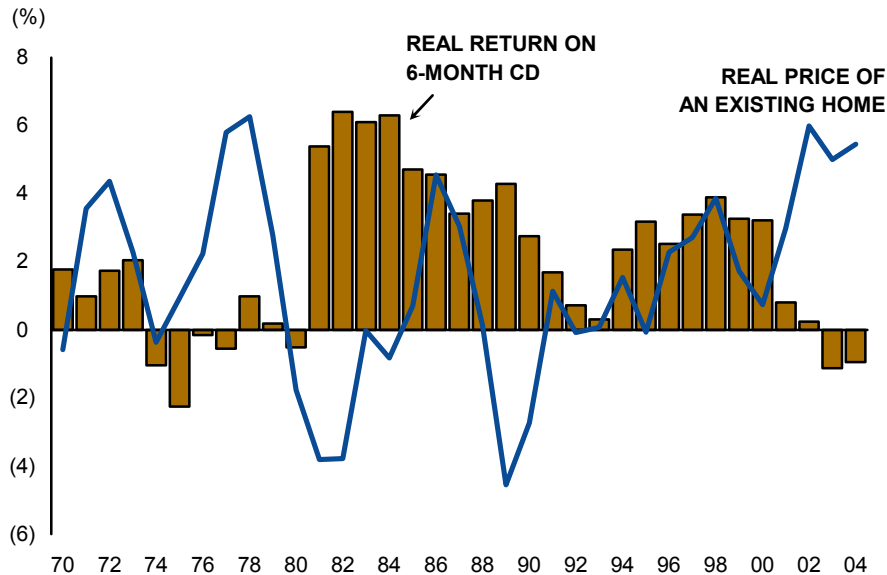


Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics and Alliance Capital Fixed Income, May 6, 2005

***Over the past 30 years, low real interest rates have tended to presage some form of inflation. In the mid-1970s, inflation surfaced in traditional price measures like the CPI and PPI. In the late 1990s, inflation surfaced in equity prices. In recent years, inflation has emerged in real-estate prices.***

## Display 2: Low Real Rates Boost Housing But Hurt Saving

Real Return on Certificates of Deposit vs. Real Price of Existing Homes



Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics, National Association of Realtors, and Alliance Capital Fixed Income, May 6, 2005

***History shows that relatively low real interest rates lessen the incentive to save and increase the incentive to own hard assets. Thus, the challenge for monetary policy is to find a "neutral" rate that encourages savings while dampening housing price increases.***