

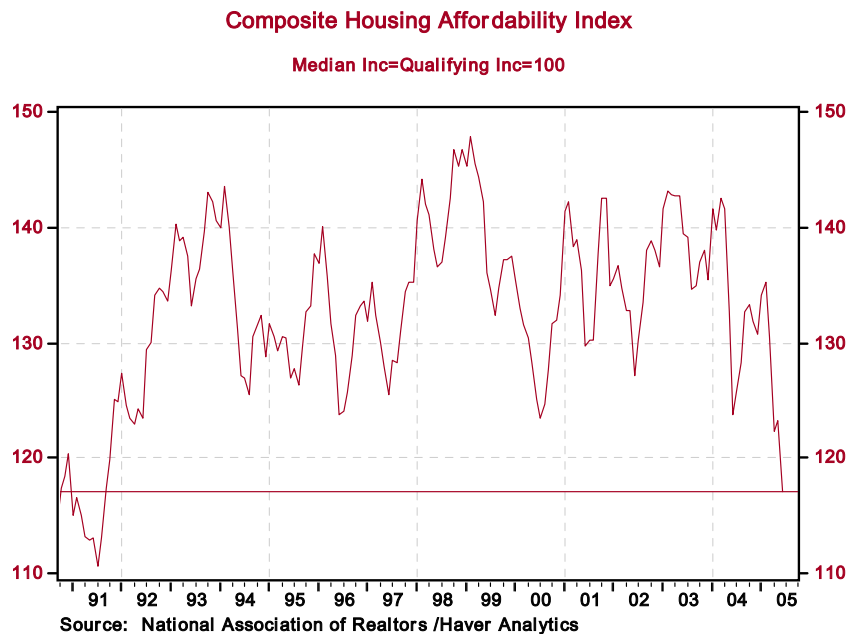


July 28, 2005

Signs of Distress in the Effervescent Housing Market?

The record breaking sales of new and existing were the highlights of economic reports in the early part of this week. This sparkling sales performance may have just met an unexpected enemy. The National Association of Realtors published the Housing Affordability Index (HAI) for June this morning. The index was reported as 117.1 in June, the lowest level since August 1991. Let us look at the building blocks of the HAI to understand why this rather innocuous economic report may contain valuable information.

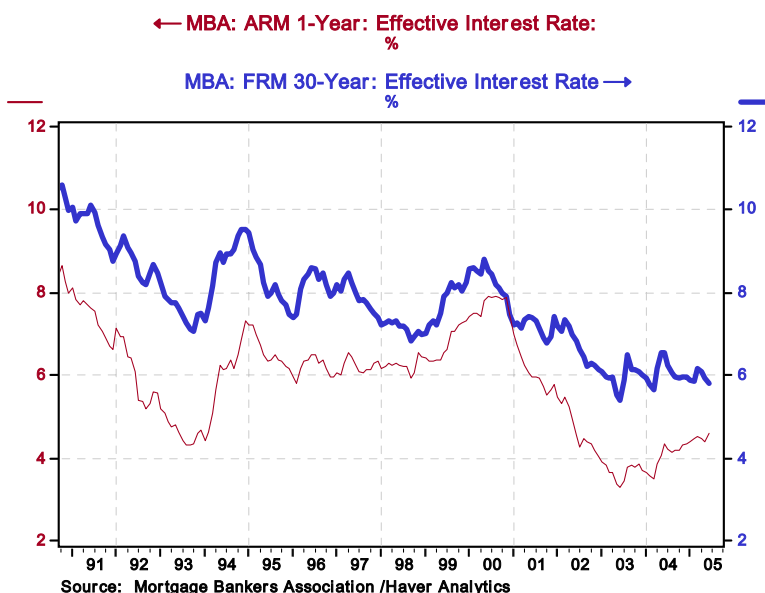
Chart 1



The HAI has a value of 100 when the median-income family has adequate income to purchase a median-priced existing home. A higher index number indicates that more households can afford to purchase a home. A ratio of 100 indicates that median-family income is just sufficient to purchase the median-priced home. When the ratio falls below 100, the typical household has less income than necessary to purchase the typical house.

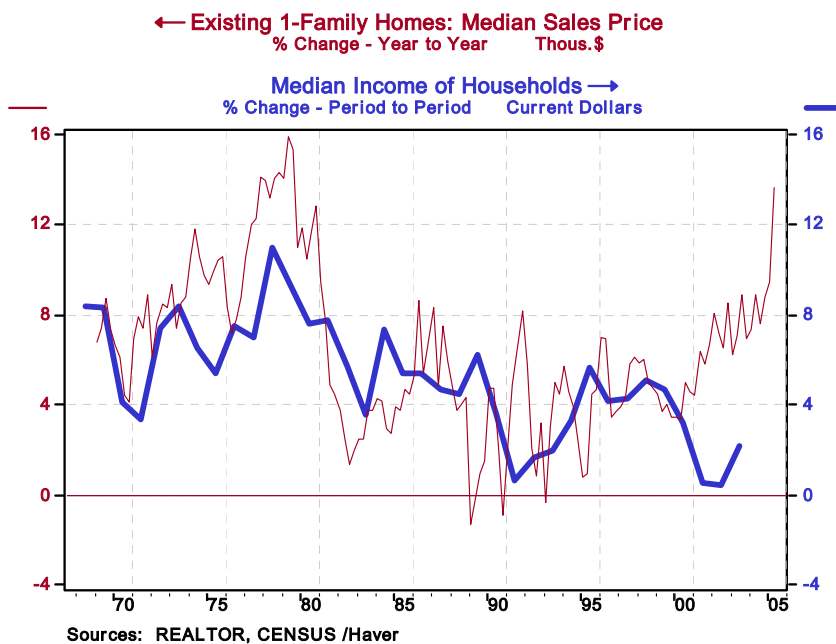
Opposing trends have been at work on the HAI. (1) The effective mortgage rate (interest and fees) has dropped, particularly since 2000, which has made housing more affordable.

Chart 2



(2) Household income has not kept pace with the rapid gains in home prices. Median household income grew less than 1.0% in 2001-2002 due to the recession. The growth of median household income in 2003 was 2.1%, far below historical average during an expansion (see chart 3). The Census Bureau has not yet published median household income for 2004. Based on the 5.8% growth of personal income it is reasonable to estimate that that median household income by no means caught up with the 8.1% increase in the median price of an existing family home in 2004 and 13.6% jump recorded in second quarter of 2005. Therefore, the growth of household income has offered little support to improve affordability in the current expansion.

Chart 3



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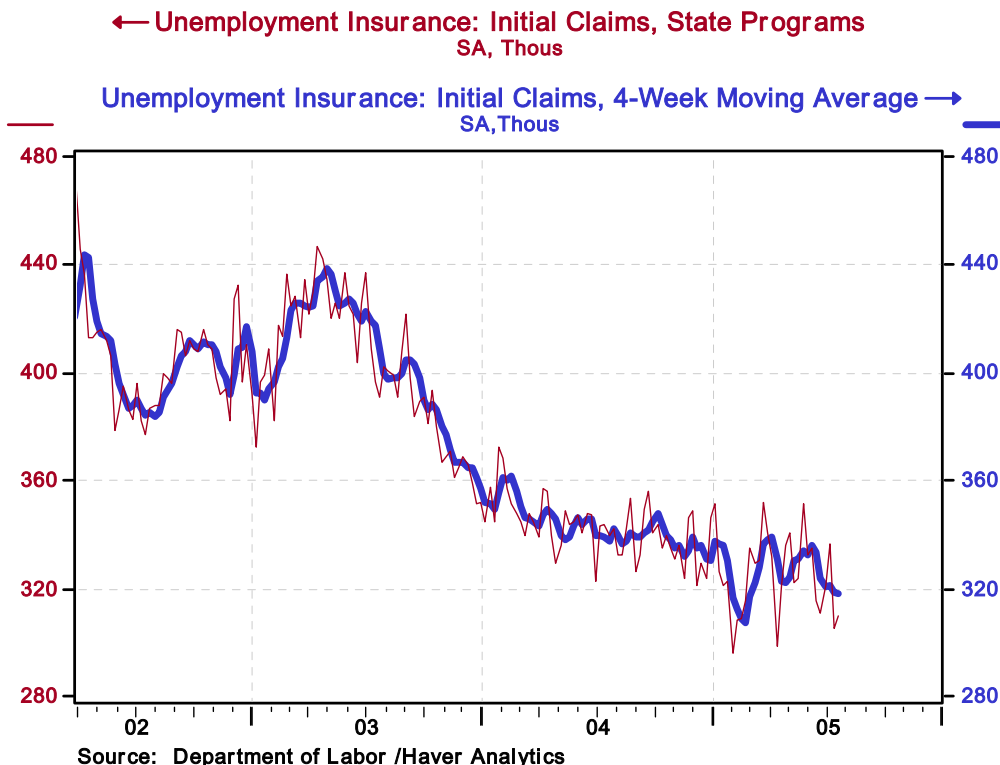
(3) Rising prices offset the positive impact from low mortgage rates and growing household income. Rising home prices, holding other things constant, make housing less affordable. Since 2000, mortgage rates have dropped, income growth has been sluggish and home prices have been soaring. In fact, home price shave grown faster than household income (see chart 3).

Conclusion – Mortgage rates today are lower than in 1991 (see chart 2) but housing affordability is the same as in 1991. Income growth has failed to match the pace of home prices and housing affordability has plunged to a fourteen year low! With home prices so high compared to income, relatively small increases in mortgage rates can have a large impact on housing affordability. Also, with a large percentage of mortgages being adjustable rate, increases in short-term mortgage rates, rates more closely tied to the federal funds rate, might be having bigger impact on housing affordability.

Initial Jobless Claims – No Discernible Change

Excluding distortions from auto retooling during in July, which should end at end of July, there is no discernible change in the jobless claims data. Initial jobless claims rose 5,000 to 310,000 during the week ended July 23. The latest increase in jobless claims follows a decline of 32,000. On a year-to-year basis, seasonally unadjusted jobless claims dropped 5.9%, almost equal to the prior week’s reading. There are too few declines of the four-week moving average to describe as improving demand for labor. Continuing claims, which lag initial claims by one week, rose 32,000 to 2.603 million and the insured unemployment rate held steady at 2.0%.

Chart 4



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