

## THE ECONTRARIAN YOUR ALTERNATIVE TO THE EONSENSUS

### Is Dave Leonhardt A Renter?

March 2, 2006

---

Northern Trust  
Global Economic Research  
50 South LaSalle  
Chicago, Illinois 60603  
northerntrust.com

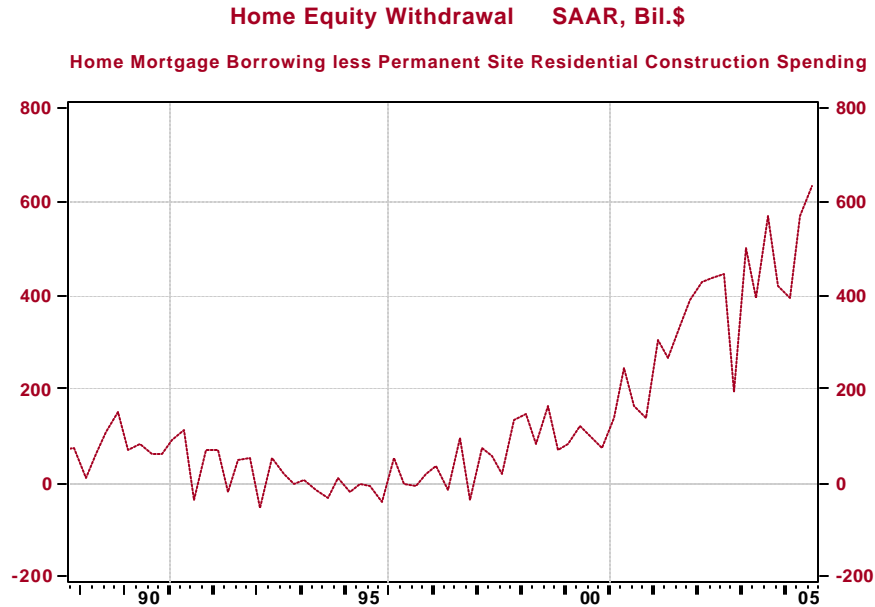
Paul L. Kasriel  
Director of  
Economic Research  
312.444.4145  
312.557.2675 fax  
plk1@ntrs.com

David Leonhardt, a journalist at *The New York Times*, wrote an article in the March 1 edition entitled “Don’t Fear the Bubble That Bursts” (<http://www.nytimes.com/2006/03/01/business/01leonhardt.html>). He’s advising homeowners not to fret too much about the prospect of declining value of the principal component of their net worth. He bases his laid-back argument on the bicoastal experience of the early 1990s’ housing bust.

According to Leonhardt, homeowners ought not to be as concerned about a potential 2006-2007 housing bust as real estate agents should. But this is partial-equilibrium thinking on the part of Leonhardt. As many of you know by now, Asha Bangalore, my colleague, has documented that about 40% of the feeble job growth in this current recovery/expansion has been housing related. Housing related would include real estate brokers. I reported a couple of weeks ago that Washington Mutual Inc., one of the nation’s largest residential mortgage lender, had announced that it was closing ten ( or 38%) of its loan processing centers, which would result in a 2,500 person staff reduction. Well, in the grand scheme of things, 2,500 workers is not even a rounding error. But we have not yet experienced the housing bust, five consecutive months of declining used home sales notwithstanding. But if we do have a housing bust – and we likely will if Bernanke does not soon declare a ceasefire – then a lot more than a rounding error of workers could be lining up for unemployment insurance. The cutback in spending by these unemployed would have a, excuse the Keynesian expression, *multiplier* effect on total spending in the economy – adding some homeowners not associated with the residential real estate industry to the length of the unemployment lines.

Today housing is indirectly playing a much larger role in funding expenditures on consumer goods and services than it did in the late 1980s. As shown in Chart 1, in the third quarter of last year, households extracted equity at an annual rate of \$633 billion, representing 7.0% of their after-tax income, from their houses. In 1989, home-equity extraction totaled only \$82 billion, or 2.0% of after-tax income. If house prices were to level off, consumer spending would be adversely affected because the “home ATM” would not be refilling. If house prices were to fall – well, I don’t even want to think what would happen to consumer spending. A slowdown in consumer spending emanating from a busted housing market would lead to an increase in unemployment, which would have further knock-on effects (Keynes was a Brit, wasn’t he?) to consumer spending and unemployment. Again, our smug homeowner might find himself in the unemployment line.

Chart 1



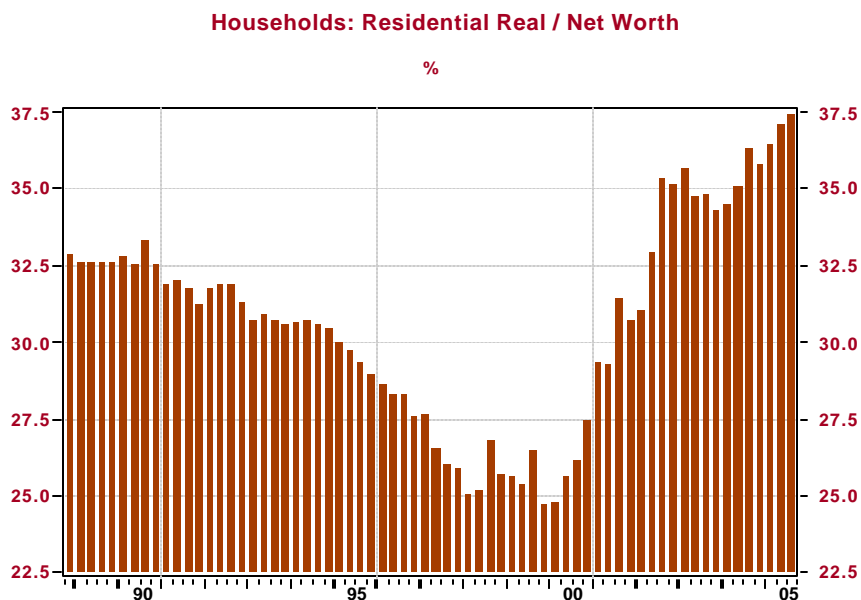
In recent years, increases in household net worth have been significantly boosted by the appreciation in residential real estate values. For example, in the first three quarters of 2005, the appreciation in the value of residential real estate accounted for 58% of the increase in household net worth. In contrast, back in 1989, real estate appreciation accounted for only 24% of the increase in household net worth. If a housing bust occurs in the next couple of years and a stock market boom does not begin, households, who in the past ten years have depended primarily on asset-price appreciation to boost their net worth might have to resort to spending less than they earn to get the job done. But if households cut back on their spending, those unemployment lines will lengthen unless some other source of demand appears quickly.

While I'm on the topic of household net worth, residential real estate now accounts for a record 37-1/2% of it – about 5 percentage points more than it did in 1989 (see Chart 2). I don't know about you, Mr. Leonhardt, but I am more inclined to spring for a night on the town when the principal component of my net worth is going up in value rather than down.

---

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Chart 2



Housing today is more highly leveraged than it was in 1989, just before the last bicoastal housing bust occurred. As shown in chart 3, today the housing leverage ratio is about 43%. In 1989, the leverage was about 35%. So what? So, as shown in Chart 4, between 40% and 50% of new mortgage debt applied for in the past two years has had an adjustable-rate element to it. Back in 1990, only about 10% of new mortgage debt was of an adjustable rate nature. A lot of these adjustable-rate borrowers in the past two years are in the “sub-prime” category or are speculators. In either case, they probably have little equity in their homes. It has been estimated approximately \$600 billion of sub-prime adjustable rate mortgages will reprice over the next two years. Chances are they will reprice at higher interest rates, not lower ones. Chances are mortgage defaults will be on the rise with these repricings. This will put “repos” on the market, which will depress home prices. Speculators, with negative cash flows and slower or no appreciation in their investment properties, also will add to the glut of homes for sale.

---

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Chart 3

**Housing Leverage: Mortgage Debt / Mkt. Value of Residential Real Estate**

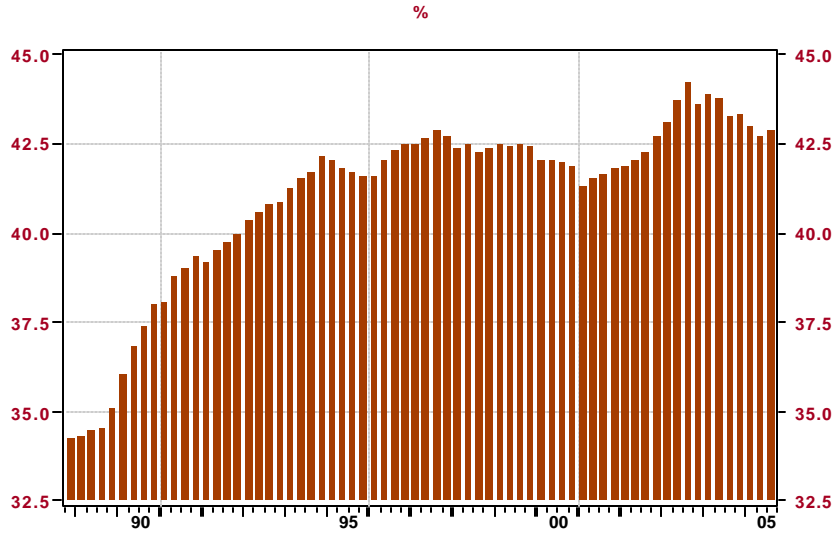
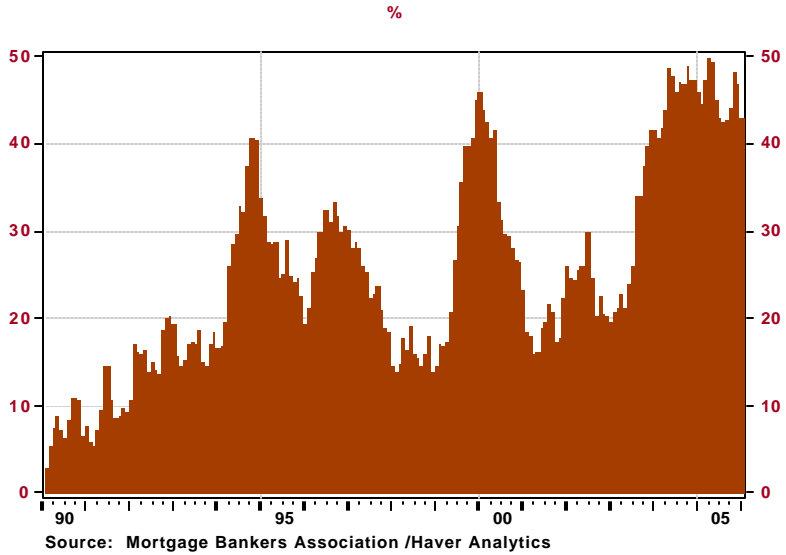


Chart 4

**MBA: Total Loans: Percent of Dollar Volume of Loans which are ARMS**

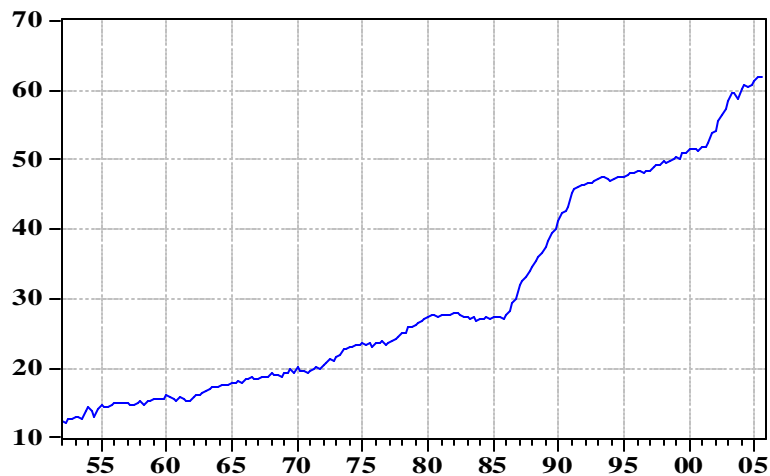


The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

Again, so what if mortgage defaults are on the rise? No biggie except that, as shown in Chart 5, U.S. commercial banks have a record exposure to the mortgage market. About 62% of bank earning assets are mortgage-related. (I do not have access to the data to determine what part of this mortgage exposure pertains to commercial properties). What I'm driving at here is the potential for a bust in housing to cripple the banking system. History tells us that a crippled banking system renders central banks less potent in combating economic downturns and promoting robust recoveries. In other words, if a housing bust led to large credit losses to the banking system, Chairman Bernanke could cut the fed funds rate to 1% and be surprised that a low interest rate did not have the same magic for him as it had for his predecessor.

Chart 5

**U.S. Banks: Mortgage-Related Assets / Total Earning Assets  
(percent)**



Mr. Leonhardt sees a silver lining in a housing bust. It will give renters a lower price point at which to become homeowners. Yes, unless they are in the unemployment line too.

---

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.