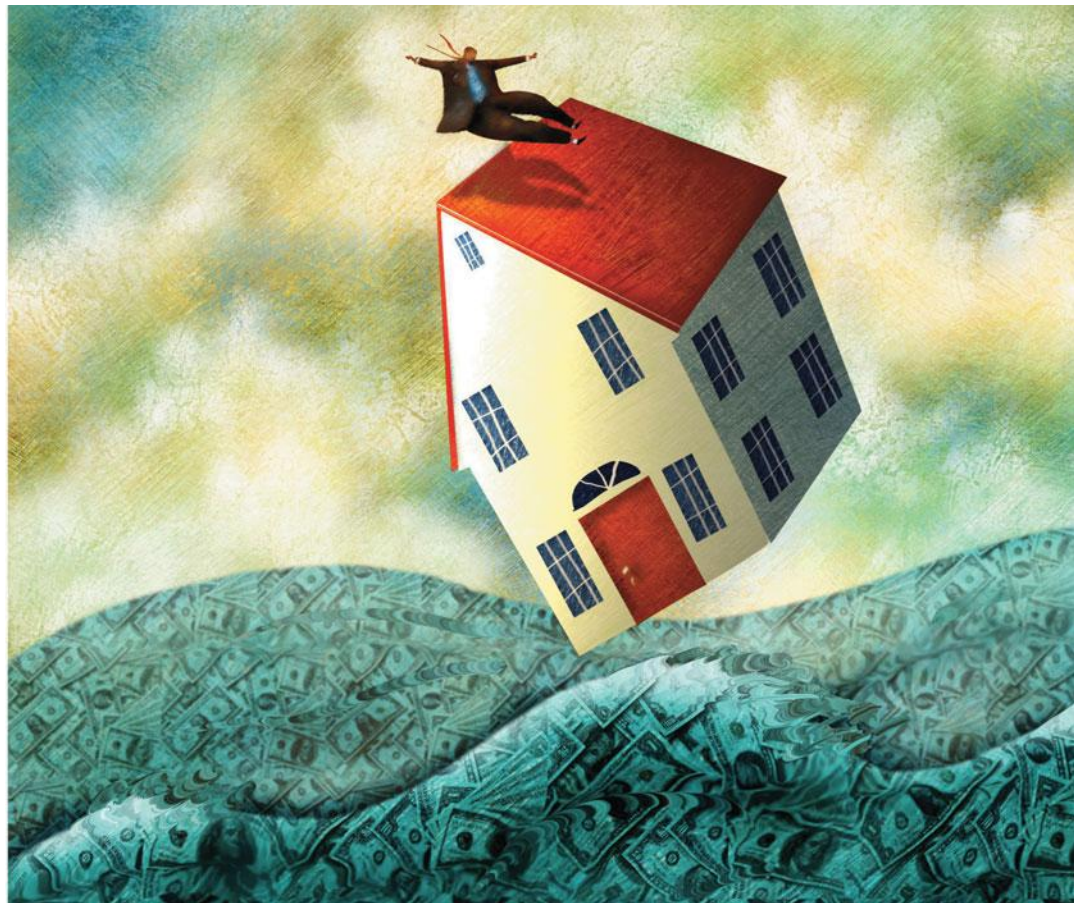


The Housing Trough

What has the Fed usually done in this situation?

By Paul Kasriel, Director of Economic Research



As 2007 opens, many people are starting to fret again about the direction and strength of the U.S. economy. In our view, that's a well-founded concern.

The Ripple Effect

We look for the economy — pressured in part by the ripple effects of a deflating housing market — to slow further during the coming months and prompt the Federal Reserve to begin cutting

interest rates this spring. Based on the excesses of the past real estate boom, the considerable supply overhang and the typical peak-to-trough behavior of residential investment expenditures, we continue to expect that the trough of the housing recession is not near. The average decline to the bottom from the peak is 25%; the median decline is 22%. Through the third quarter of 2006, these expenditures are down only 7.9%.

“You Ain’t Seen Nothing Yet”

We continue to hear that the weakness in the housing market has not spread to other parts of the U.S. economy. To that, we say, “Not so” and “You ain’t seen nothing yet.” The year-over-year growth in combined real personal consumption and business equipment and software expenditures, at 3.1% in the third quarter, is the slowest since the second quarter of 2003 and is down 130 basis points from its year-ago growth. That takes care of the “not so.”

Regarding the “you ain’t seen nothing yet” argument, year-over-year behavior of residential investment expenditures leads the behavior of the rest of the U.S. economy, typically by two calendar quarters. This implies that even if the trough of the housing recession is at hand, the full ripple effect of the weak housing sector has yet to reach the rest of the economy. Moreover, if the housing-recession trough does lie ahead, the wave action from this sector will continue through most of 2007.

Home “ATM” to Slow Accruing

Another reason we believe the recession in housing will have a lingering retarding effect on economic activity is its effect on the “home ATM,” i.e., mortgage equity withdrawal (MEW). With home prices either falling or advancing more slowly, depending on the price series used, it stands to reason that growth in homeowner equity would be slowing.

After peaking at an annualized rate of 14.50% in the second quarter 2005, growth in homeowner equity slowed to only 0.53% in the third quarter of 2006. So, the home ATM is not refilling as rapidly as it has in recent years. The slower growth in home equity, along with the higher level of mortgage and home equity loan interest rates, is slowing MEW, an important source of funding for household spending in recent years. After peaking at an annual rate of \$730.5 billion in the third quarter 2005, MEW has slowed to an annual rate of \$214.2 billion in the third quarter

this year. Of course, corporations continue to fund household deficit spending. In the third quarter, corporations “retired” a record \$566 billion of their equities at an annual rate, which accounted for a record 5.9% of disposable personal income.

Why has the stock market continued rising as economic growth weakens? Because corporations have been reducing the supply of their equities at a record pace. A lot of the so-called liquidity sloshing around in the stock market is record profits that are being used to finance stock buybacks and acquisitions of competitors rather than to expand the scale of operations of corporations in the aggregate. The retirement of corporate equities is being used to expand the spending of households beyond their current after-tax income.

Fed Likely to Cut Rate

What does all this imply for near-term Federal Reserve interest rate policy? On a year-over-year basis, we are forecasting real gross domestic product (GDP) growth of only about 2% in each of the first three quarters of 2007. Since 1960 — with only one exception — whenever the year-over-year growth in real GDP slowed to 2%, the Fed started cutting the federal funds rate. The only exception was 1974, when inflation was soaring. With overall consumer inflation already well below its cyclical peak (September 2005) and with core inflation now behaving as though it is near its peak, 2% year-over-year real GDP growth in the first quarter 2007 would likely induce the Fed to cut the funds rate.

In sum, we believe that sub-par economic growth lies ahead, inflationary pressures are subsiding and the Fed at its January 31 meeting is likely to hint that it is contemplating a rate cut. At its March 21 meeting, we expect the central bank policymakers to begin a cumulative 100-basis-point decrease in the federal funds rate by trimming 25 basis points from the funds rate, which currently stands at 5.25%. ■