RWW

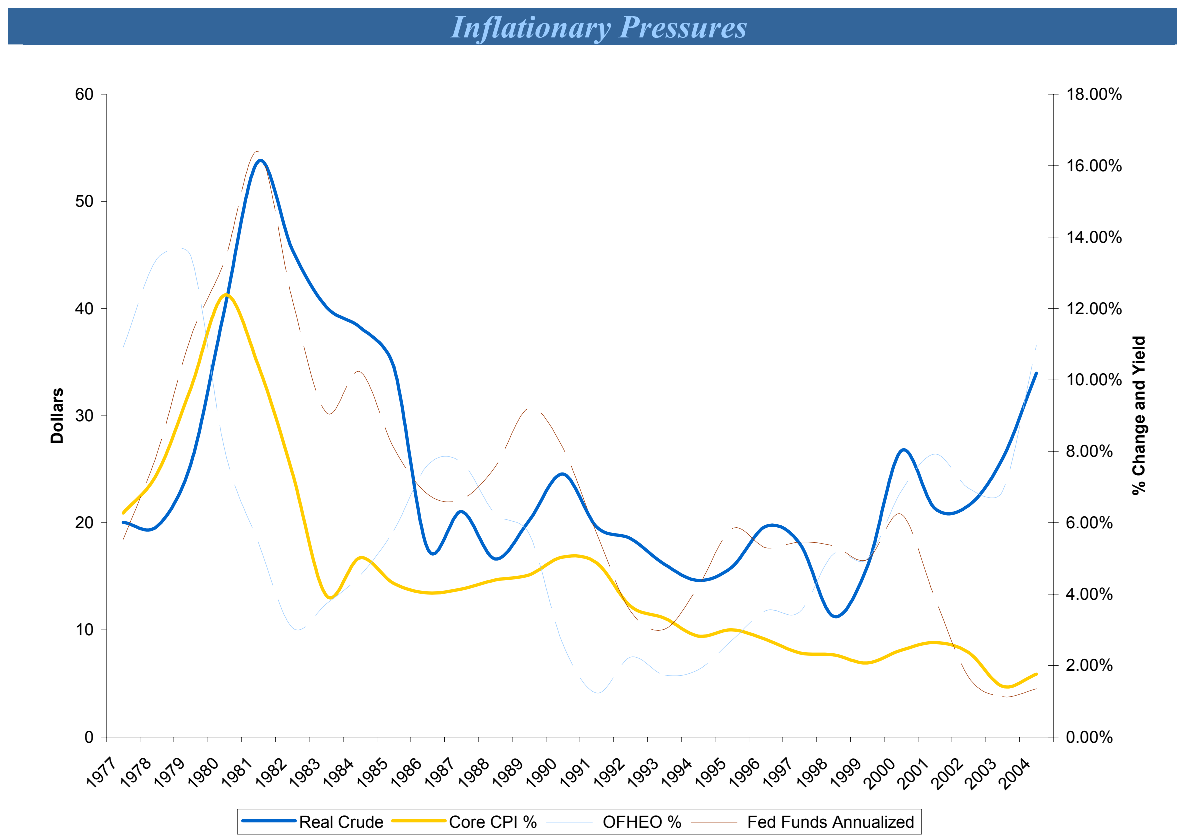
That's Hot

Sam S. Park – December 2005
sam@rwwentworth.com

Inflation on the Way

Paris Hilton describes a trendy item or a passing fad by claiming "that's hot." Perhaps that's how she'd depict some real estate markets in the U.S. Lately there have been some contradicting views about the current state of our economy. Some maintain that the economy remains strong and real estate price levels do not merit concern. On the other hand, some argue that certain pressures will eventually crack the adamant economy.

Well, exactly how hot is the U.S economy? GDP figures suggest that our economy has been continuing to grow at a healthy pace despite some of the negative exogenous factors (i.e. Hurricane Katrina, etc.). However a rapidly growing economy usually comes with inflationary pressures, and in turn with rising interest rates. The chart below illustrates the three decade trends in oil price levels, annualized fed funds rate, and core CPI and housing price percent changes (OFHEO).



Source: US Department of Energy, Bureau of Labor Statistics, Office of Federal Housing Enterprise Oversight, Federal Reserve

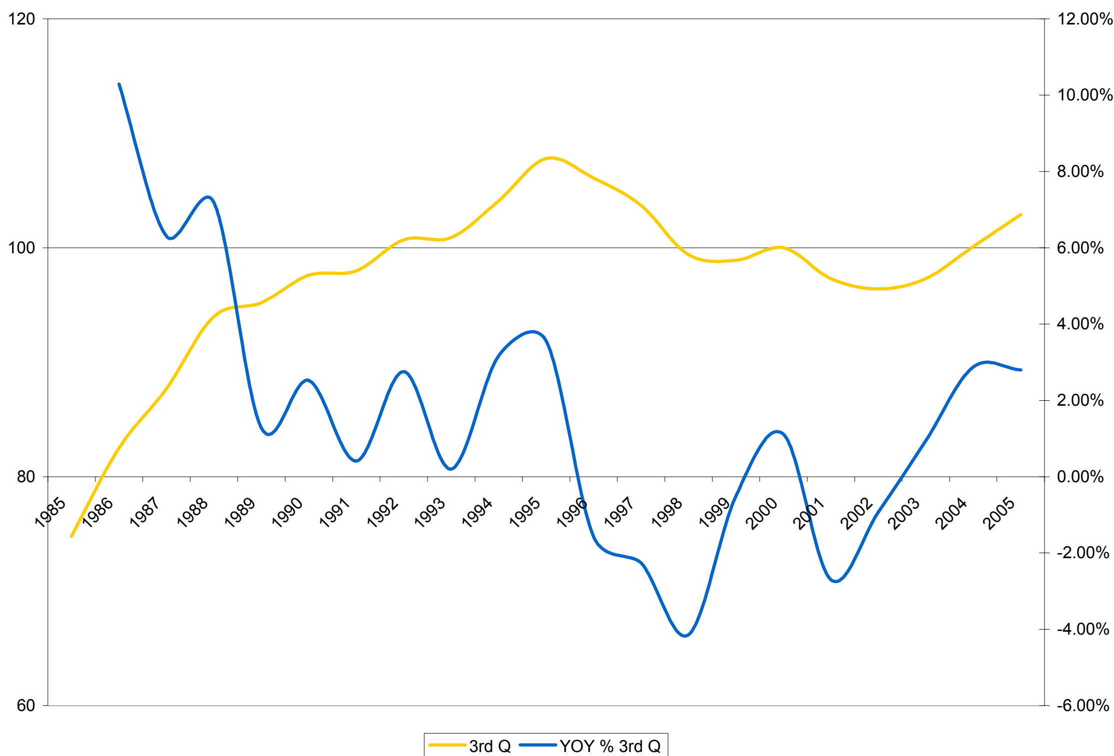
Particular attention should go towards the widening gap between oil and housing, and fed funds and core CPI through the first half of the recent decade. Core CPI has been on a downward trend since Mr. Greenspan had stepped into office. Many attribute the U.S. economy's success to the Chairman's dealings with inflation, growth and crisis. For instance, when the tech bubble popped in 2000, the Federal Reserve responded by reducing the fed funds rate to avoid a hard landing scenario. Although Mr. Greenspan had engineered a soft landing by lowering rates, the extremely cheap credit fueled the housing market.

Even though core CPI currently remains low, oil and housing prices have risen to their highest levels seen in the Greenspan era. Nevertheless, factors such as decelerating import prices and accelerating productivity have significantly contributed to the low core CPI.

Import Prices

Macroeconomics taught us that free trade benefits economies that apply such policies. By trading with trading partners that have lower cost of labor and/or comparative advantage, the U.S. benefits from lower priced goods to its consumers. Sure some domestic producers lose from the competitive prices, but that's the cost of progress towards efficiency. Opening up trade has allowed our import price increases to decelerate over the past two decades.

Import Price Index: Excluding Petroleum (2000=100)

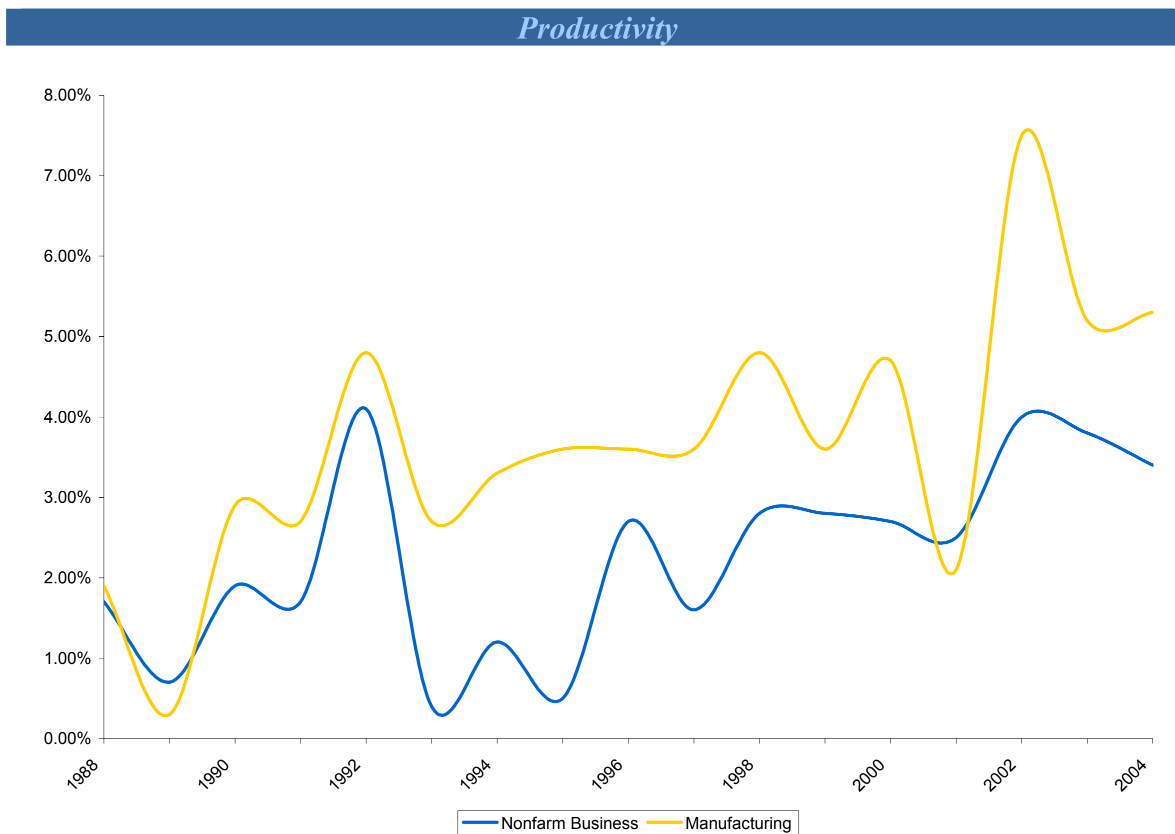


Source: Bureau of Economic Analysis
** Based on 3rd Quarter Levels*

The chart above indicates that, based on 2000 dollars, import prices rose from mid 80s to mid 90s however at a decelerating pace. From mid 90s to the earlier part of this decade, we've even experienced deflationary trends in import prices. The recent deflationary trend had reversed in 2003. While the recent pace remains relatively low, tariffs such as the one proposed by senators Schumer and Graham would push import prices to the upside. That would seem like an inflationary danger that neither Mr. Greenspan nor Mr. Bernanke would want to see.

Productivity

Investments in technology such as software have not only helped GDP be robust, but they have also helped our productivity to increase.



Source: Bureau of Labor Statistics

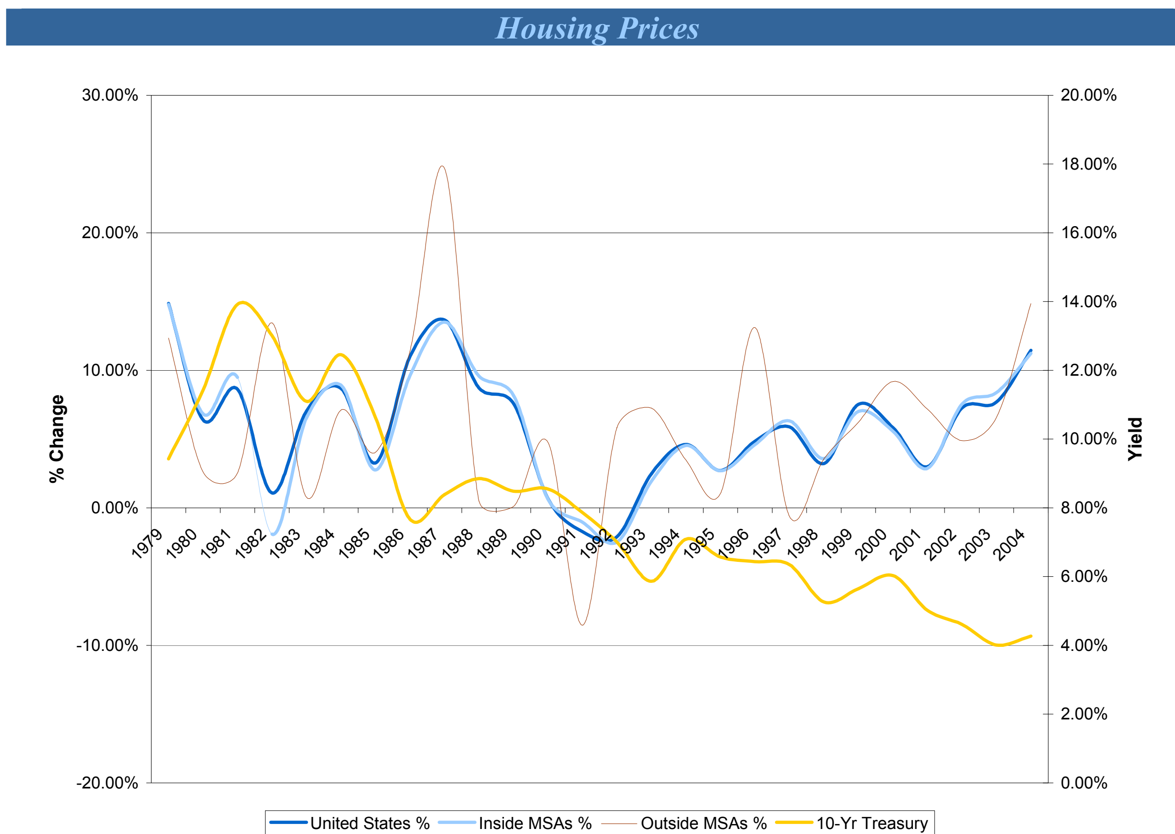
The above graph confirms the accelerating trend in output per hour in both non-farm business and manufacturing sectors. This rising trend in productivity has kept costs per output moderate, which has helped keep core inflation low.

Maintaining competitiveness lingers on all success oriented CEOs' minds. This remains particularly true for those who face limited growth opportunities. Many companies have turned to technology to increase efficiencies in various areas of business operations. Information is important, but intelligent analysis of that data matters more when it comes to making critical decisions.

Enterprise Resource Planning (ERP), Customer Relationship Management (CRM), and Supply Chain Management (SCM) solutions providers have been offering software products and services to companies that seek to stay competitive. By applying these solutions, companies have been able to increase efficiency and productivity.

Housing Prices

The dramatic increases in housing prices indicate a booming real estate market. The growing demand for houses and the ability to buy them can be seen from falling long-term rates. Mortgage lenders typically use 10-year and 30-year Treasuries to set long-term mortgage rates. In general, rising rates have inverse effects on housing prices (in terms of percentage changes).



Source: US Census Bureau

The above chart illustrates the percent changes in housing prices for overall U.S., inside and outside MSA (Metropolitan or Micropolitan Statistical Area) versus the 10-year Treasury yield. Since the mid 90s, the rising acceleration trend in overall housing prices in the U.S. has corresponded to the falling 10 year Treasury yields. The growing appetite for these long-term Treasuries from both domestic and foreign institutions has contributed to the falling rates of these debt instruments.

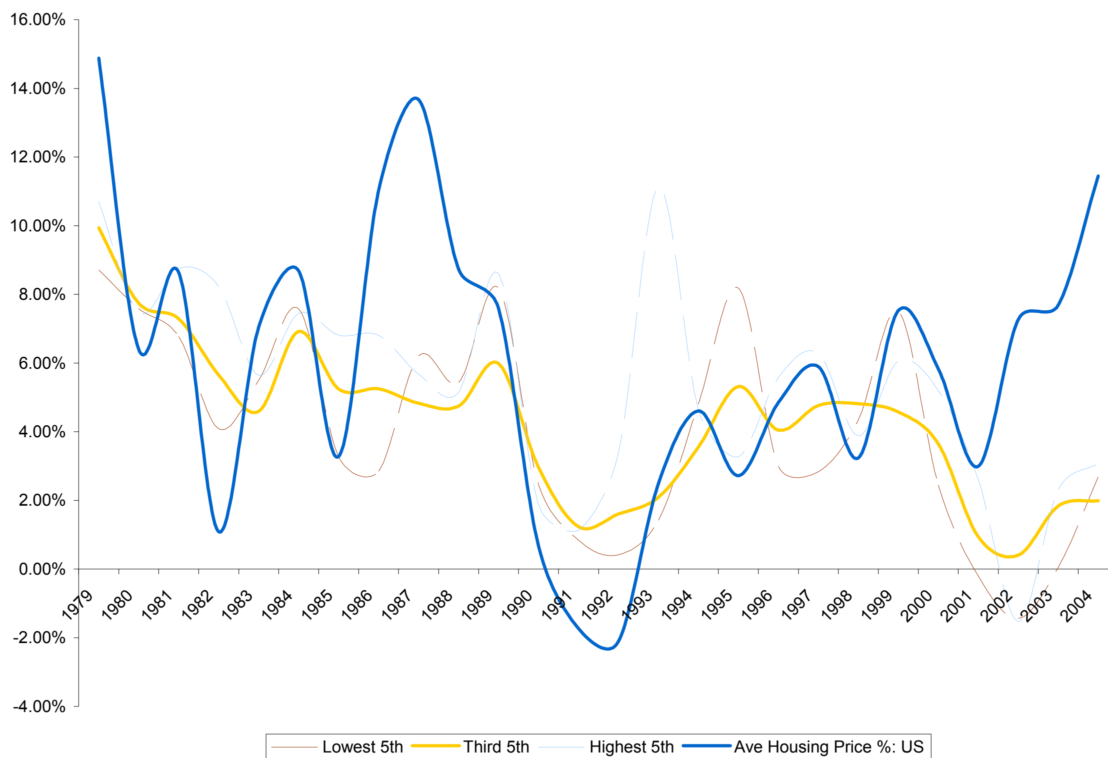
This historical look at housing prices indicates that a decline in housing prices has thus far been rare. The only time, within the past three decades, that prices actually fell was in 1991 through

1993. A historical perception on housing prices would imply that a soft landing scenario in housing assets is more likely than that of a hard fall. However other circumstances call for a cautious outlook on real estate.

Can We Afford These Homes?

Excess capital coming into the U.S. has kept interest rates relatively low. As mentioned, the cheap money had fueled the soaring American housing market. But can we really afford the current housing price levels?

Income Versus Housing Prices



Source: US Census Bureau

The above chart plots the percent changes in U.S. household income (lowest fifth, middle fifth and highest fifth) and U.S. housing prices. As previously pointed, a negative percent change in overall U.S. housing prices occurred in the earlier part of the 90s. This fall followed the period when the gap between the percent changes in housing prices and income levels had widened. As we can clearly see in the above graph, this widening gap seems to be plaguing us once again.

Another cause for concern comes from the methods of financing these purchases. The emergence of subprime mortgage lending in the 90s has allowed millions of home buyers who could not qualify for conventional loans to purchase unaffordable homes. According to the Federal Deposit Insurance Corporation, subprime mortgage loan originations soared by 25 percent yearly

between 1994 and 2003.[1] The FDIC also notes that such increase in subprime mortgage lending has been associated with higher levels of delinquency and foreclosure. Financing methods like interest-only seem extremely dangerous for those unaware home buyers who have used such methods. These instruments resemble more a time bomb than a means to achieving the American dream. These delicate situations (questionable financing methods and their rising use) do not appear to be something that we've seen in U.S. history – at least something within the past three decades.

Either the income levels will have to accelerate drastically to allow homeowners to afford these homes, or the prices will have to come down to realistic levels, for our economy to progress. In the former case, that would translate into wage inflation, and the latter case would indicate a slowing or falling economic health. If inflation occurs, the Federal Reserve will continue to raise rates, which will likely slowdown the spending patterns.

The New Chairman

I fully respect Mr. Greenspan, but the current Chairman looks as if he's getting out at the right time - for his own sake. Perhaps the heat in the kitchen is too hot for anyone to handle. If history persists, Mr. Bernanke will face a crisis early into his term, as did his predecessors. And academically speaking, the new Chairman has the backing to handle theoretical occurrences.

Mr. Bernanke is known for his proponent views towards inflation targeting policy. If the Federal Reserve officially accepts the inflation targeting policy, not much will actually change. This policy calls for transparency, which is something that has been accomplished by Mr. Greenspan. The biggest difference resides in the actual set target range (i.e. 1 to 3 percent inflation allowance).

The current FOMC has already made it clear that inflation rests at the top of its priority list. So, is an official policy change really necessary? One could argue that countries that have applied inflation targeting policy have fared well, but then again so has the U.S.

Inflation targeting comes in various forms from strict to loose. These forms include inflation target range, government collaboration and transparency levels. Some opponents to this policy have express their concerns about flexibility. This concern also includes what indicator the Fed would use as their inflation measure. What would Mr. Bernanke do in times of crisis? I suppose only time will truly tell. In the meantime, the President's top economic advisor will be on top of inflation and its pressures if he has any say - as Chairman of the Federal Reserve.

Three Blind Mice

It appears that some people have covered their eyes and ears to the warning signs. I applaud the U.S. economy's recent resiliency in the face of negative pressures. However, this does not mean that our economy is immune to painful punches. Such blows will take a toll on any entity, however strong. However, some claim that all is well, and no one should worry. I would categorize those people into one or more of the blind mice.

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[1] http://www.fdic.gov/bank/analytical/fyi/2005/021005fyi.html

The first blind mouse couldn't see inflationary pressures. Those too focused on core CPI figures determined by the BLS may be in for a surprise. High gas and home prices will drive higher wages. Higher wages in turn may push up producers' costs, which would be even worse once and if productivity decelerates. Certain senators continue to push Chinese authorities to appreciate the Yuan or else accept the consequences. Either way, relative import prices per goods and services from China (which totaled $196 billion in 2004)[2] are likely to rise either from a weaker dollar or tariffs. These factors appear to have inflation written all over it.

The second blind mouse couldn't see the need for interest rate hikes. It's true that the Fed may have moved too aggressively in the past. However Mr. Greenspan's era did not experience any major recession and has seen more growth than declines. Much of this success came from the attempt to stabilize price levels. Part of this inflation fighting requires pre-emptive moves before runaway inflation becomes evident, and this realization would summon aggressive rate hikes. Such extreme movements in rates would likely cause higher volatility in an economy, which would likely results in more hard landing scenarios than soft ones. The inflationary pressures that I've mentioned are some of the reasons that have called for subtle pre-emptive moves.

The third blind mouse couldn't see the heightened dangers of the housing market. Property flippers have been claiming that bubbles are for baths, suggesting that real estate will not experience a bust. One should note that those flippers are the same people that need buyers to take the flippers' properties. Recent history implies that a probability of a nominal decline in housing prices is low. However, the widening gap between housing prices and wages suggest that a reversal in home prices is right around the corner. The currently hot markets will likely be the biggest victims. Not all markets will face dire consequences, but certain home buyers who have used exotic financing may find an unwelcome surprise in their mortgage bills in the near future. One thing that would cause widespread delinquencies in mortgages would be major job losses. Companies like GM who plans to cut up to 30,000 jobs by 2008 are not helping this delicate situation.

The U.S. economy has been going strong over the recent period. The economy has weathered terrorist attacks and the tech bubble burst without going into a major recession. We have thus far absorbed record level oil prices, exhausting war-efforts in Iraq and devastating hurricanes. However, it's evident that bruises have surfaced, and a thorough diagnosis may reveal more injuries really exist. A real (inflation adjusted) look may reveal the true picture.

For questions and/or R.W. Wentworth & Co., Inc.'s (RWW) forecasts and advisory services, contact the following:

- **RWW**
- **Alan Rude**, President
- **Tom Au**, Executive Vice President
- **Sam Park**, Senior Associate

[2] U.S. International Trade Commission

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