Weak Housing = Consumer Bust?

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

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As U.S. housing activity has weakened, a number of economists are raising concerns that the consumer has finally had it, that consumers will begin to cut back their spending and that the economy will be thrown into recession. These economists also argue that, as U.S. growth falters, growth overseas will begin to contract. We believe this position greatly underestimates the resilience of the U.S. consumer.

While it is undeniable that the housing sector is in decline and that home prices are teetering after years of huge gains, we do not think this sector is collapsing. The housing sector appears to be going through a normal cyclical retrenchment after a period of abnormally strong gains. Although this adjustment period could last for years, it is important to put the housing weakness into perspective.

The U.S. economy is huge and diversified. Real GDP in the U.S totaled $11.4 trillion in Q2. Although residential construction fell 9.8% in Q2, the economy still managed to grow 2.9%. This is because residential construction represents only about $602 billion, or 5.5% of real GDP. In comparison, real exports of goods and services totaled $1,285 billion in Q2, while real high tech spending by consumers and businesses totaled almost $775 billion. All of this spending was dwarfed by the over $8 trillion (inflation adjusted) in real consumer spending during Q2.

Although consumers may be buying fewer homes and construction activity is slowing down, other industries, such as aerospace, industrial machinery, technology, energy, healthcare, finance, recreation, entertainment and home improvement, can pick up the slack. The U.S economy is extremely diverse, dynamic and resilient. It is not dependent on any one sector for growth.

The consumer balance sheet is strong

The consumer has benefited from robust housing activity and rising home prices. With prices beginning to fall and refinancing activity collapsing, it is fair to ask, "Where will the money come from to continue spending?"

The stereotype of Americans as profligate consumers, spending every dime they earn plus all the equity in their homes, is overstated. Consumers have behaved rationally as incomes and asset levels have grown. While consumer debt has risen, consumer assets have gone up even faster and net worth has continued to expand. From a balance sheet perspective, consumers look solid. Despite their negative personal saving rate, household net worth rose $4.9 trillion over the past four quarters to a record of $53.2 trillion.

Homeowner equity accounted for only 21.4% of this net worth. Although this is a significant percentage and rising home prices have contributed to rising net worth, we believe wealth is not as skewed toward this one asset class as the pessimists claim. Household net worth includes stocks, bonds and trillions of dollars in non-corporate business equity, as well as homeowner's equity. America is not just a country of profligate spenders, but a country of investors and entrepreneurs as well.

Cash-out refinancing will slow, not collapse.

Although consumers have extracted $4.6 trillion from their homes since the beginning of 2000, homes have appreciated $10 trillion and equity has increased $5.4 trillion. Both the value and the equity of homes are at record highs. With over $11 trillion in homeowner equity, consumers have plenty of unrealized gain left to tap.

In addition, not all the money extracted from housing went to spending. Since 2000, U.S. households have put $3.3 trillion into stocks, bonds and cash equivalents. The rest of it went to paying off credit card debt and to home improvement that added value to existing properties. Although equity extraction will slow, we believe it should not cause consumer spending to tumble.

Are adjustable rate mortgages coming back to bite?

A recent Business Week cover shows a coiled snake around a house with the

title, "How Toxic Is Your Mortgage?" Inside, the article talks about the ticking time bomb of option adjustable rate mortgages (ARMs) and predicts a "wave of defaults" that will create a housing bust. From a contrarian standpoint, such magazine covers are a sure sign this won't happen. A little over a year ago, the cover of Time showed a happy homeowner with his arms wrapped around his house with the title, "Home Sweet Home" and an article that extolled the virtues of homeownership...a sure sign of a market top.

The current scare suggests that, over the next few years as the ARMs taken out in 2003, 2004 and 2005 are reset at higher mortgage rates, homeowners will be unable to make their mortgage payments and be forced to cut spending, sell their homes or face foreclosure. As consumer spending is cut and housing prices fall, a severe recession would follow.

One need not be a contrarian to argue that this is alarmist rhetoric. Clearly many homeowners with ARMs will be hurt by rising mortgage rates. However, we believe that if you step back and look at the big picture, this is not a calamity in the making. According to the Mortgage Bankers Association, ARM originations totaled $1.1 trillion in 2003 and $1.3 trillion each in both 2004 and 2005. Assuming a 2% per year cap on rate increases and that all of this debt was rolled at once, total mortgage payments would rise $74 billion. Consumer spending which totaled just under $9.4 trillion in July would only be reduced marginally. Given that mortgage interest is tax deductible, the after-tax loss of purchasing power would be even less. In addition, not all this debt will be rolled at once, so the hit to the consumer will be spread out over several years. Some of this debt has already been rolled over into fixed-rate loans as rates bottomed and began to rise. Furthermore, some of this debt is held by high income earners who chose to borrow and put their money to better use. These households are unlikely to default. The final point is that the consumer holds over $4.5 trillion in saving deposits and money market funds which are earning over $125 billion more than two years ago. In other words, on balance, the household balance sheet is positively impacted by rising interest rates.

Employment and income growth is the key.

We don't expect a "negative wealth" effect from housing and view the consumer balance sheet as very strong. Although we believe equity extraction will slow, we don't think it will have a big impact on consumption. We also view rising interest rates on ARMs as having only a marginal impact on consumption. The real driver of consumer spending is job security and consumer income. Consumers that are secure in their jobs spend money. Over 2.2 million jobs were created over the last year. Although job growth has moderated over the last few months, it remains healthy at a 1.8 million job annual pace. With employers hiring, the unemployment rate of 4.8% and layoffs at a relatively low level, job security is high.

In addition to more people working, Americans are working more hours and earning more money. Wages and salaries rose 7.9% year –to-year in July while personal income increased at the fastest rate since the 1990's.If employment continues to grow, unemployment remains low and wages and incomes rise, the consumer is likely to continue to spend and to remain resilient in the face of slowing home price appreciation. Going forward, consumption growth is likely to be related to job and income growth more than housing and house prices.

Sources: Bailard Research, Business Week, Federal Reserve Flow of Funds, Bear Stearns, Oak Associates, Bloomberg,

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Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404