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American housing market: a source of relief or weakness?

Roller-coaster interest rate expectations

Investors are being whipsawed by data and speculation about the intentions of the Federal Reserve. Two weeks ago, it was all about the Medley report that said that the Federal Reserve would quit raising interest rates soon. Bonds rallied, the dollar swooned and equities took heart from that. The week that just ended saw the opposite scenario played out. Chairman Bernanke did not share the view that a flat to inverted yield curve presaged a recession, let alone an economic slowdown.

Sales of existing home sales rebounded. Initial jobless claims dropped this week. Durable goods orders were modestly up. Bond yields rose and rate hike expectations were put back. Then, on Friday, came the release of data on sale of new homes. It dropped 10% and it was the biggest drop in nine years. In the immediate aftermath of this report, the US currency gave up some ground against the Euro and other major currencies. Bond yields dropped and rate hike expectations were pared back again.

FX market reading likely to be incorrect – USD to benefit from a slowdown

We would deal with this market action from two angles: (a) was the collective market reaction internally consistent? (b) Was the logic of a slowdown correct? I have deliberately sequenced the questions in this order.

My answer to (a) is NO. The bond market interpreted the drop in new home sales as heralding an economic slowdown via a slowing consumer spending and an imminent peak in the Federal funds rate. If this interpretation is correct, then there is no reason for the US dollar to drop. Slowing consumer spending would mean a big improvement in the US trade deficit. This is what happened in 2001. The US economy slowed, consumer spending growth declined, the trade and current deficit improved and the US dollar rallied although the Federal funds rate dropped to 1.75% from 6.5%.

Hence, the reaction in the foreign exchange market – pared back towards the end of the day on Friday, however – presents buying opportunities in the US dollar, if persists.

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In general, if there is an economic slowdown in the US, it would reduce the US current account deficit (which is a big issue in the eyes of the market) and still preserve a modicum of rate advantage for the US dollar. Both are positive for the US dollar.

If the US economy remains strong and the Federal Reserve continues to tighten monetary policy, then the US dollar should continue to benefit from a widening rate advantage over other major currencies and shrinking rate disadvantage over the current high-yielding currencies.

Potential US dollar downside risks

There are only two risks to the scenario of a stronger US dollar: (i) the Federal Reserve stops tightening for fear of bursting asset bubbles or precipitating a financial market crisis but the economy continues to chug along nicely, pushing trade deficit higher. That would be negative for the US dollar; (ii) US politics takes a turn for the worse with the President not only becoming a lame-duck after the mid-term Congress elections but also becomes a vulnerable to any impeachment threat as a fall-out of the Iraq quagmire and other policy errors made. For now, both are scenarios.

Slowing housing = Slowing economy?

The second question that I had posed earlier is whether the bond market's interpretation of slowing new home sales equals slower or negative growth in consumer spending and hence a weaker economy. My stance is that the bond market is jumping the gun here.

First, Credit Suisse research (*US Interest rate strategy weekly, 24 March 2006*) points out that monthly decline in new home sales of around 10% have occurred about 14 times in the last twenty years and that on average the following month has seen an increase of 6%.

Slowing new home sales is a rational response to the impressive run-up in home prices and shrinking housing affordability, in the last few years. Many research papers have pointed out that the housing sector would cool down through a reduction in volume of homes traded rather than through a steep correction in prices.

Unless prices fall, current home-owners might not feel poorer or less wealthy. Even if they do, it is not clear yet if it would impinge on their spending habits, as no real wealth is lost.

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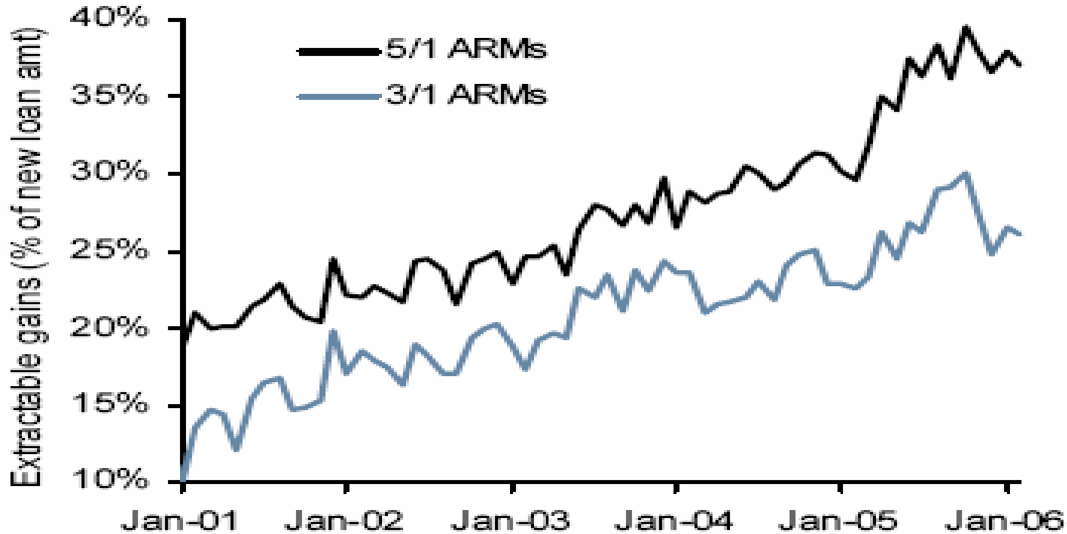
Of course, equity extraction from homes would drop. To the extent that such equity extraction from rising values of homes supported consumption growth in the last few years, there is a clear risk here. Even here, Credit Suisse research points out that the median price of existing homes rose at an annual rate of 11% in February. It is down from the rise of 17% last year and that is consistent with a soft landing in prices rather than a destabilising downward lurch. The chart below, taken from Credit Suisse research cited above, shows that there is still plenty of cash to extract from a home financed with 80% LTV (Loan-to-Value).

Exhibit 3: Homes financed with resetting 3/1 and 5/1 ARMS have significant embedded gains

Amount of cash available to extract on an 80% LTV refi of homes financed 3 or 5 years ago at median home prices and average LTVs.



Source: Credit Suisse US Interest Rate Strategy Weekly, 24 March 2006

Furthermore, it is entirely possible that the drag – minor or significant – from the absence of equity extraction is offset by rising wages and improving employment prospects. The annual growth rate of average hourly earnings is now 3.5% compared to just around 1.6% two years ago (see next chart). It is not too far below the growth rate of around 4.0% seen in the growth era of the Nineties.

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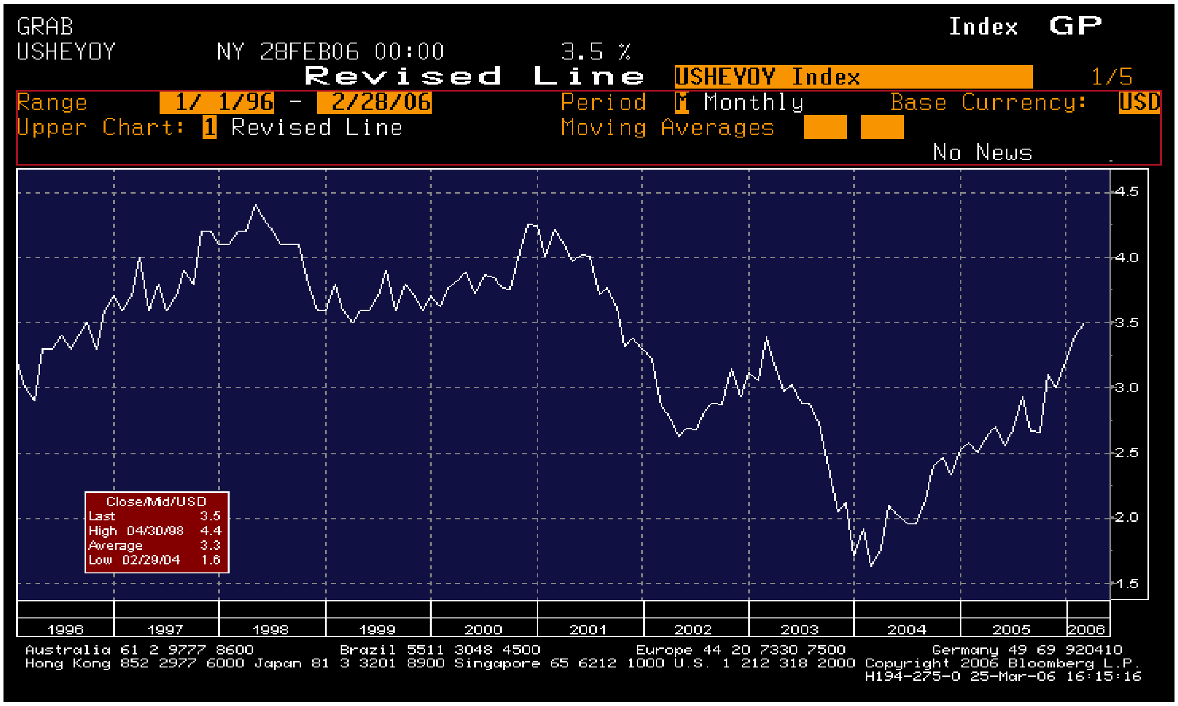

Annual percentage change in Average Hourly earnings of US non-farm workers. Sources: US Dept. of Labour and Bloomberg.

Apart from housing, all other sectors of the economy appear solid. Hence, in conclusion, we can state the following:

(1) It is premature to turn negative on the US dollar. If any thing, any dollar weakness still represents a buying opportunity, particularly against the major currencies.

(2) Bond market strength on weak housing data appears premature and hence, the US 10-year Treasury yield, if any thing, should trade towards the upper end of the range from 4.4% to 4.8%.

But then, one speculates on the bond yield going higher at one's peril, as the first half of last year showed. It is hard to bet against the combined might and determination of the Asian (East and West) central banks.

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