TFP

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HARD or soft?

When the stock market bubble burst in 2001 it didn't wholly deflate. Instead, interest rates remained far below normal historical levels and were driven down still further by a US Federal Reserve (Fed) that was operating off of inaccurate inflation data. The Fed's decision to fight deflation from 2001 to 2003 relied heavily on generating a boom in US consumer spending and property prices. This boom spread throughout the world sending borrowing rates for emerging markets to unprecedented low levels and property prices soaring worldwide.

Since the dotcom crash real estate has been a pillar (we'd argue bubble) of the American economy. However, seventeen consecutive rate hikes by the Fed are finally working their way through the US economy.

We are now in the midst of a significant pullback in the American housing market which could have a wide ranging impact on the US consumer and on the global economy. That's because homes are the most important asset for many households. Nearly two-thirds of the typical American family's net worth is accounted for by home ownership. In contrast the typical family has little exposure to the stock market since share ownership is more concentrated amongst the wealthiest households.

Even a modest decline in home prices could be challenging for the economy because of the huge increase in mortgage debt in recent years. When home prices were increasing at a double-digit

clip, many home owners were using their homes like ATM machines. With home prices now under pressure, a significant slowdown in credit growth seems likely. While the Fed aims for a reduction in credit growth to dampen inflation, they must also be hoping to avoid a recession.

So will it be a hard or soft landing for the American economy?

Given the strong ties between property and GDP growth in the US, it is reasonable to assume the landing may not be a soft one. Residential property investment is now off by 17.4%, the biggest such contraction in more than 15 years and inventories of unsold homes are up by 40% on an annualised basis.[1] If past cycles going back to 1959 are any guide, housings starts decline an average of 47% during a pullback; thus far they are off about 24%, so the worst could lie ahead of us.[2]

To make matters worse, housing has been as much a source of consumer spending as it has of employment: the housing market has accounted for one-in-four of all new jobs since 2001. Real estate activity accounts for 0.5% of the average 3.9% US GDP growth over these past three years. It is now forecast that a significant erosion of property values could knock 1.5% off this average growth rate. This level of slowing would be a hard landing for the broader US economy.[3]

Since 2003 world GDP has grown an average of almost 5% per year. There is a good case to be made that this number was too high to be sustainable. As the American economy typically generates about one quarter of world GDP growth per year, we could be looking at a 12% to 15% reduc-

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(Hard or Soft? cont'd)

tion in global GDP growth figures.

This is not to say other economies won't pick up some of the slack. Europe, Japan and a number of emerging economies where monetary policy remains accommodative also have rising domestic demand trends. It is the Anglo-American nations that have short-term interest rates higher than long-term rates, usually a harbinger of recession.

As the American housing market slows, jobs will be lost and consumer spending will slow. Does that mean the external trade deficit will stabilize or even decline? If so, that could cause problems for emerging market nations who have relied on providing consumer goods to Americans.

Several emerging market nations, such as China, have pegged their currencies at artificially low levels against the US dollar. This appears to have caused these countries' producers to over-invest in manufacturing capacity. Several countries seem to be counting on continued strong sales to American consumers. The risk is that if the American consumer's spending slows in response to a weak housing market, these countries will be left with excess capacity. Excess capacity is likely to put downward pressure on prices and profits, which will leave producers no choice but to cut back on investment spending.[4]

A slump in American consumer spending could also have a knock-on effect on commodity prices. The impact on commodities could result from a decline in demand associated with a slowdown in US home building and on investment spending in China and in other emerging economies.

However, over these past few years, economic growth has induced one of the largest agrarian to urban population migrations in history. The emergence of Chinese and Indian middle classes will continue to put demand on basic materials.

Therefore, a floor on commodity prices is likely because of the industrialisation of these two potential economic giants.

Naturally, China and India would like progress on reducing trade barriers. Free-trade helps emerging economies improve their lot. Consumers enjoy free-trade too (compare today's prices on a DVD player with five years ago). A Democratic ascendant Congress and Senate, however, may complicate events. Their protectionist sentiments are well known and they may thwart any easing of barriers to trade that have done so much to lift so many out of poverty.

With over 75% of our exports going to the US, Canada will not be unaffected by an American slowdown or rising protectionism. The manufacturing heartland of Ontario and Quebec is already under pressure from our (relatively) stronger dollar. Slowing commodity prices could have a sobering effect on the booming west and on Canadian property prices.

America's is the most dynamic and resilient economy in the world. But even America may not be impervious to the effects of a slowing housing market.

The repercussions could be worldwide.

Be prepared.

Sources:

1. The Economist, 4 November 2006
2. Northern Trust Global Economic Research, Paul Kasriel, 3 November 2006
3. Front Street Capital – Commentary Q3 2006
4. Sterling's World Report, William Sterling, CI Funds, 30 September 2006