High Frequency Economics®

Daily Data Analysis and Assessment of the Global Economy

Weekly Notes on the United States

May 26, 2009

Worldwide Edition

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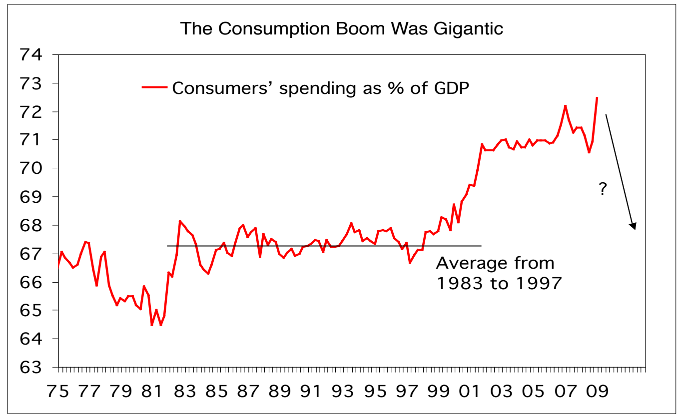
The New Normal

President Obama said last week that there has been "some return to normalcy" in financial markets. That's certainly true if your primary interest is in Libor rates, but that's about as far as it goes. As for the real economy, we can't talk about a return to normal until we define what normal actually means. *In our view, the new normal, by which we mean the first two or three years after the economy stops contracting, will be very different from anything we came to see as normal during the boom.*

The key issue for us is the disappearance of home equity credit, because it was so instrumental in raising consumers' spending and, hence, fostering the illusion that we were all richer than we really were. The numbers here are truly staggering. From 1983 to 1997, the share of consumption in GDP averaged 67.3%. By 2007, however, it had risen to 71.6% of GDP, as our first chart shows. We define excess consumption as the difference between the level of spending that would have kept consumption at 67.3% of GDP and the actual numbers. In the decade from 1998 through 2007, excess consumption totalled $2.87B. Over the same period, the Fed's estimate of mortgage equity withdrawal, using the method pioneered by Greenspan and Kennedy, was $3.03T. ***In other words, equity extraction financed* all *the excess consumption during the boom.***

This was great while it lasted. At the peak of the boom, the average homeowner was making as much—notionally, at least—from home price appreciation as he was making from going to work every day. *No wonder people felt tempted to extract part of that price appreciation in order to spend on cars, vacations, clothing, jewelry and all manner of other stuff and experiences.* But even people who felt they were acting prudently have now found themselves in trouble.



An example using real world data is instructive. Suppose you bought a single-family house for the national average price, $228K, in May 2003. If you put down 20%—which in most cases made you a prime borrower—your starting mortgage was $182K. Over the next year, the home appreciated by 15.4%, according to the Case-Shiller index. Let's suppose you chose to extract and spend half your $35K notional gain, leaving the other half in the property. By the standards of the day, this was prudent.

If you extracted half the gain over the next two years as well, then when home prices hit their peak in May 2006 your property would be worth $335K and your mortgage would be $228K, assuming you took out a 30-year fixed rate loan at 5.5%. *You now have $107K equity, more than twice as much as you put in when you bought the home just three years ago, and you have enjoyed spending a total of $54K in equity extraction.* This, you might think, is magic: More spending and more equity.

Alchemy, more like. Let's wind the tape forward to February this year, the latest month for which Case-

HFE's Economic Forecasts

GDP	Q3 final	-0.5%	2007 year: 2.0%
	Q4 final	-6.3%	2008 year: 1.3%
	Q1 advance	*-6.1%*	*2009 year: -2%*
	Q2 forecast	*-2%*	*2010 year: 1-to-2%*
	Q2 forecast	*-3%*	
CPI	Apr: 0.0% (-0.4% y/y); core 0.3% (1.9% y/y)		
	Jun. 2009 forecast: -1.1% y/y; core 1.8% y/y		
	Dec. 2009 forecast: -2.0% y/y; core 1.6% y/y		

Unemployment: Jun. 2009, 9.5%; Dec. 2009, 10.8%.
Federal budget FY 09 forecast: -$1.75T (12.3% of GDP)

HFE's Financial Forecasts

		End-month:			
	4:30 pm Friday	**Jun**	**Sep**	**Dec**	**Mar**
Fed funds	0-to-0.25	0-to-0.25 through Mar 10			
2-yr	0.87	0.75	0.75	0.75	1.00
10-yr	3.41	3.00	2.50	2.25	2.00
30-yr	4.34	3.75	3.25	2.75	2.25
Curve 10-2	254	225	175	150	100
Curve 30-2	347	300	250	200	125
Dow Jones IA	8277	8000	8000	8000	8500

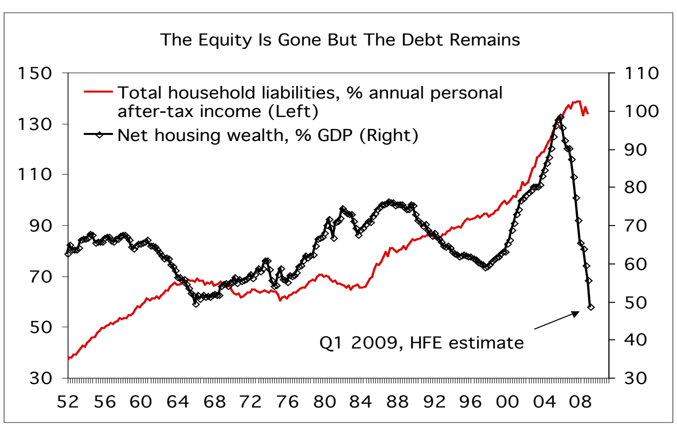
Dollar: Safe haven funds move to dollars from euros, sterling and yen. Dollar flat vs. loonie, down vs. Ozzie.

Shiller home price data are available. Prices have dropped by a cumulative 29.9% from their peak, so your home is now worth $235K, and your mortgage is $228K. Your equity is now down to just $7K. Assuming a cumulative 3% drop in prices in March and April—that would mark a clear slowing in the rate of decline, so we're being optimistic—you now have no equity at all. This month, May, you slip underwater. *And you'll stay there, sinking deeper, for the foreseeable future.*

This, remember, is the fate of a prime borrower who extracted only half the price gains in the final three years of the boom. Run the math again using someone who put down only 10%, and you find they are now underwater to the tune of about $23K. *In other words, when home prices fall rapidly for a sustained period, it's not just the reckless subprime borrowers who find themselves owing more than their homes are worth.*

The cumulative loss of housing wealth since the peak in home prices is now some $5.6T. In Q1, the annualized rate of loss of housing wealth will exceed the entire GDP of China. As a share of GDP, net housing wealth has fallen to the lowest level since records began in 1952. ***And this is why a return to the normalcy of the go-go days is impossible. Home equity is the collateral base of the household sector, and it is evaporating.*** Even if the banks were all magically fixed tomorrow, and even if they all wanted to lend to consumers at something like the pace of the go-go days, they could not, because there is nothing like enough collateral left to lend against. To this extent, this is reminiscent of the Japanese situation in the nineties, though in that case it was the collapse in stock prices which wiped out the collateral base of the corporate sector.

The key point of all this is that we have to change what we think of as normal. In a credit-constrained economy, spending can only rise in line with real disposable incomes, and they are under pressure too. The share of consumption in GDP has to fall all the way back to its long-term trend, and that will take years.



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This Week In Brief

*Note: "**SS**" prefix denotes Snapshot for these data.*

Monday, May 25

- **Memorial Day Holiday**

Tuesday, May 26

- **Redbook Chain Store Sales (5/23)/9:00 EDT**
  *Sales growth has slipped in recent weeks. We expect a result similar to last week's **-0.3%** year-over-year.*
- **SS: Case-Shiller Prices (3)/9:00 EDT**
  *The rate of decline seems to be slowing. For March we look for a 1.5% drop, lifting the year-over-year rate to **-18.1%** from -18.6%. **Consensus: -18.4%.***
- **SS: Consumer Confidence (5)/10:00 EDT**
  *The headline index should jump to **46** from 39.2, led by rebounding expectations. **Consensus: 42.8.***

Wednesday, May 27

- **MBA Mortgage Applications (5/22)/7:00 EDT**
  *A modest rebound from last week's **254.0**?*
- **SS: Existing Home Sales (4)/10:00 EDT**
  *Sales should rebound to about **4.70M** from 4.57M. The trend is flat. **Consensus: 4.66M.***

Thursday, May 28

- **SS: Initial Jobless Claims (5/23)/8:30 EDT**
  *Claims should dip to about **620K** from last week's 631K. **Consensus: 630K.***
- **SS: Durable Goods (4)/8:30 EDT**
  *Orders should rise about **1%**, with a **0.6%** increase ex-transportation. **Consensus: Total Orders 0.4%, ex-transport -0.3%.***
- **SS: New Home Sales (4)/10:00 EDT**
  *The jump in homebuilders' sentiment suggests sales should reach **400K** for the first time since October, up from 356K in March. **Consensus: 363K.***

Friday, May 29

- **SS: GDP (Q1p)/8:30 EDT**
  *Growth should be revised up to **-5.8%** from -6.1%, thanks to stronger inventory and trade numbers. **Consensus: -5.5%.***
- **SS: Chicago PMI (5)/9:45 EDT**
  *To stay in line with the Philly Fed, the headline index needs to rise to **43** from 40.1. **Consensus: 42.0.***
- **Univ. Michigan Sentiment (5f)/10:00 EDT**
  *Little change from the preliminary **67.9**, up from 65.1 in April. **Consensus: 68.0.***

This Week's Funding

Tues:	Auction—$31B 3-month, $30B 6-month bills
	Announcement—4 week-bills (May. 27)
	Auction—2-year notes
Wed:	Auction—4 week-bills
	Auction—5-year notes
Thur:	Announcement—3-mth, 6-mth bills (Jun. 1)
	Auction—7-year notes