

The Fragile Economy

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Haveman



BEACON *Economics*

Macro-Economic Forecasting

Rule 1: Forecasts are Always Wrong
Good Forecasters are *Less Wrong*

Rule 2: Forecasting is all about...



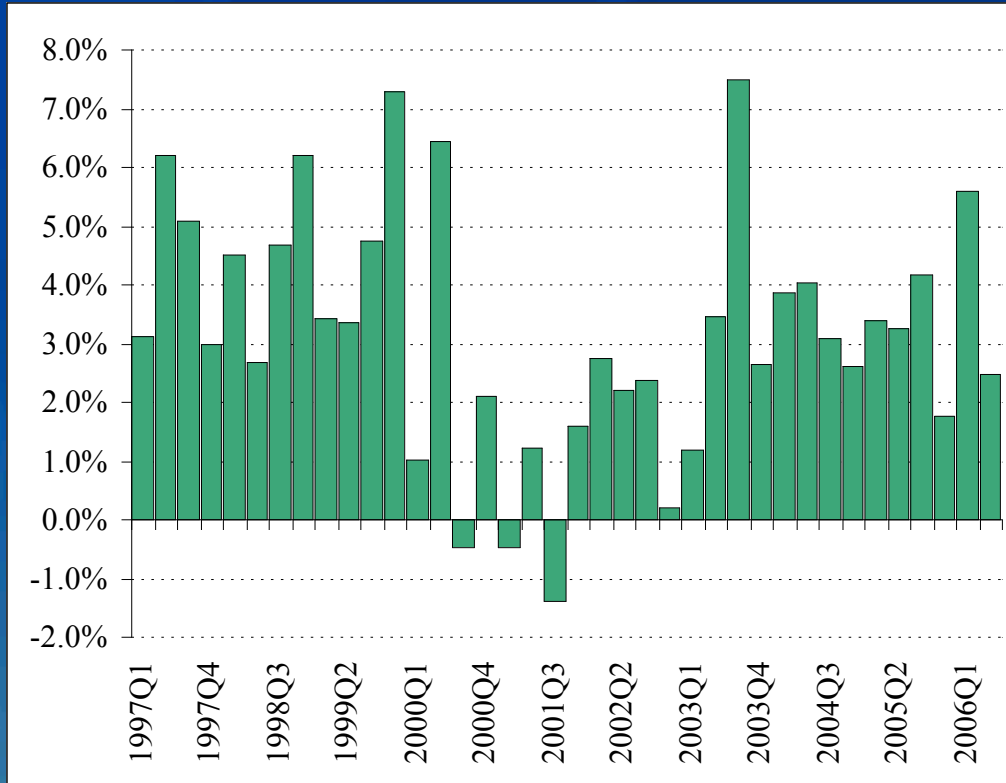
Trends
and
Bends

Trends and Bends

- The trends
 - Weakening Labor Markets
 - Moderate income growth
 - Inflationary concerns
- The bends
 - Real estate, real estate, real estate
 - Interest rates
 - Consumer debt



US GDP Growth: Slowing

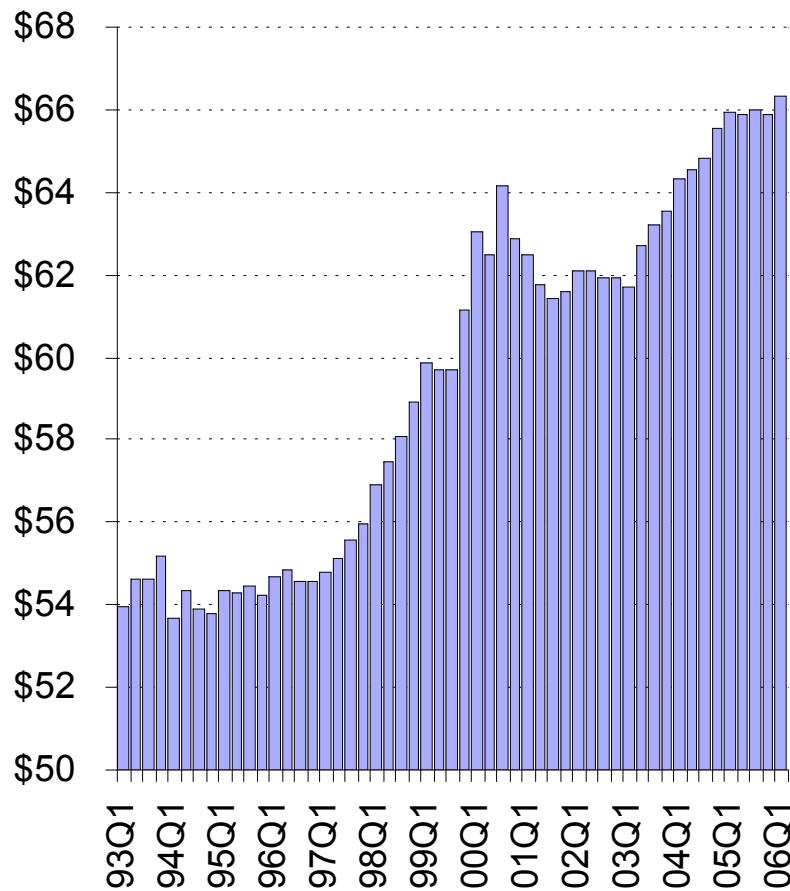


	<i>3 Yr Avg</i>	<i>Q4 05</i>	<i>Q2 06</i>
Gross domestic product	3.80	1.80	2.50
Personal consumption	2.57	0.53	1.74
Durable goods	0.59	-1.08	-0.04
Nondurable goods	0.84	0.79	0.34
Services	1.15	0.83	1.43
Gross investment	1.24	2.51	0.28
Nonresidential	0.70	0.52	0.28
Structures	0.08	0.31	0.36
Equipment	0.63	0.21	-0.07
software			
Residential	0.46	-0.06	-0.40
Change in inventories	0.07	2.05	0.40
Exports	0.79	0.97	0.35
Imports	-1.18	-2.04	-0.03
Government	0.36	-0.21	0.11

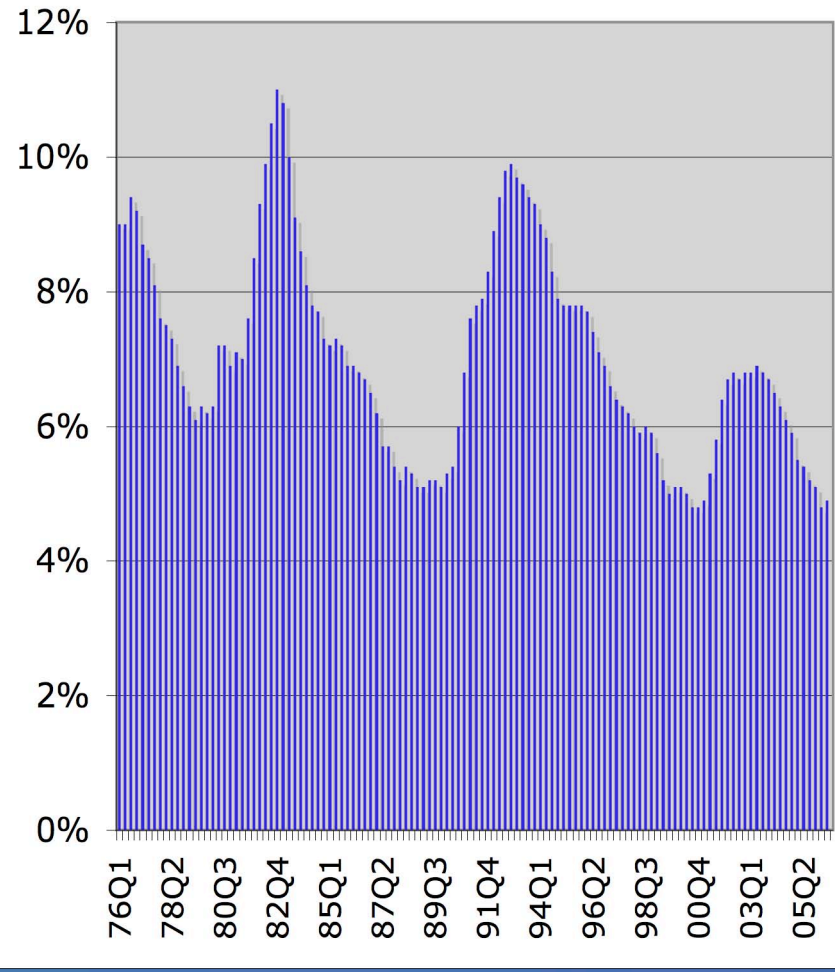


California: Better than ever

California Per Worker Income (\$000, Real)

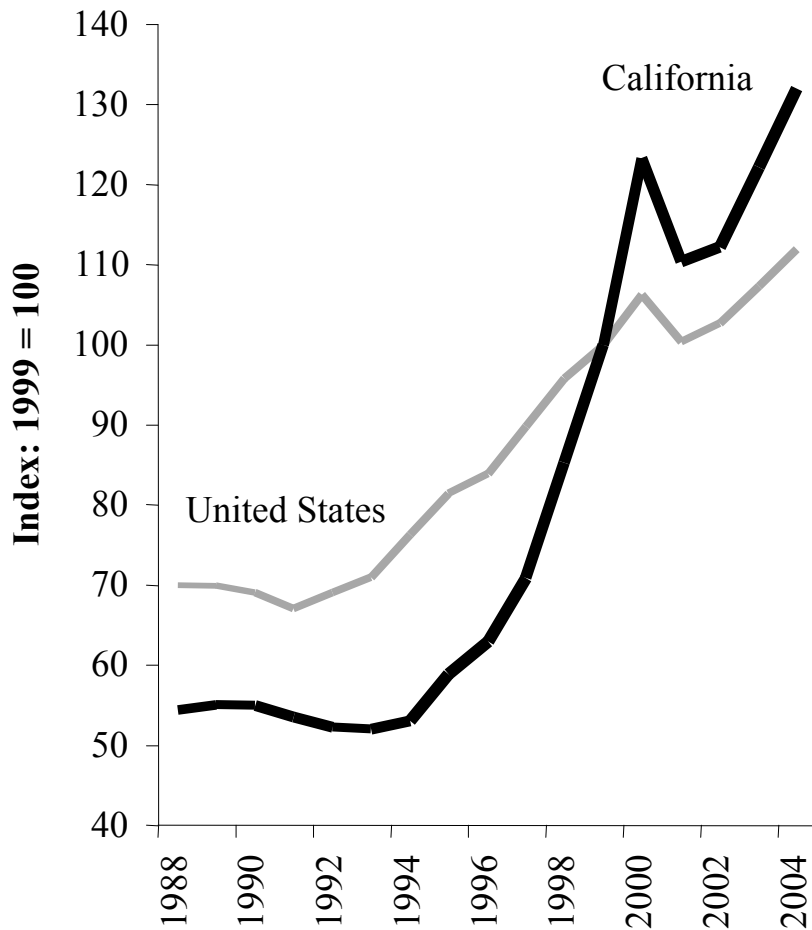


California Unemployment Rate

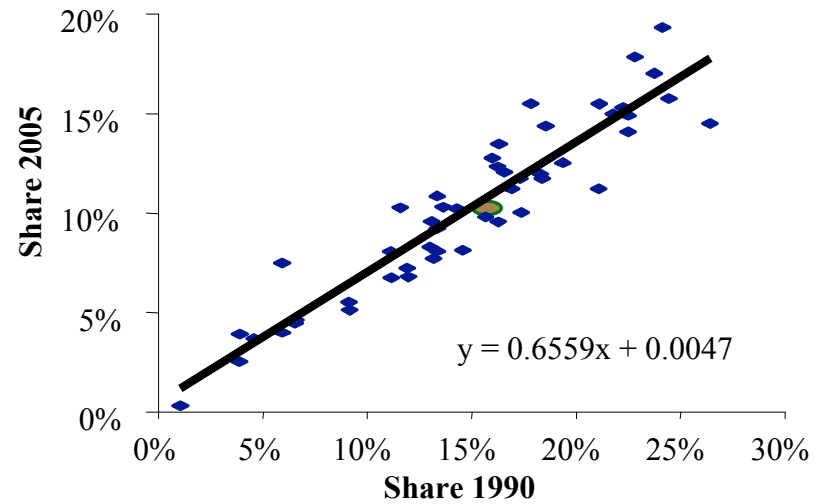


Wither California Manufacturing?

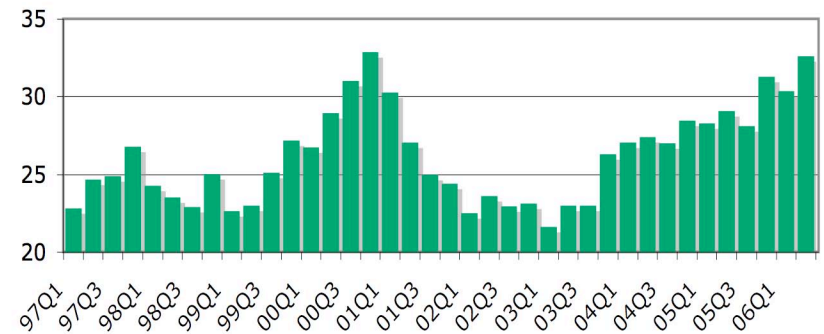
Real Manufacturing Output



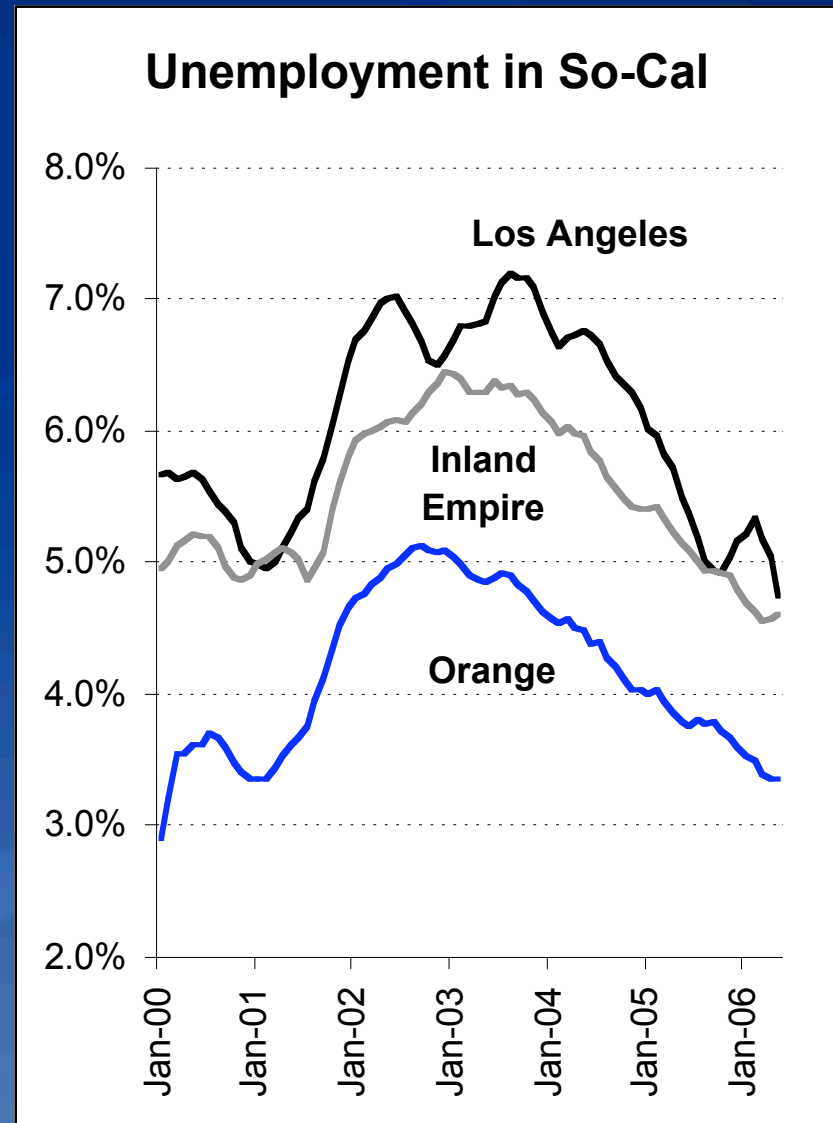
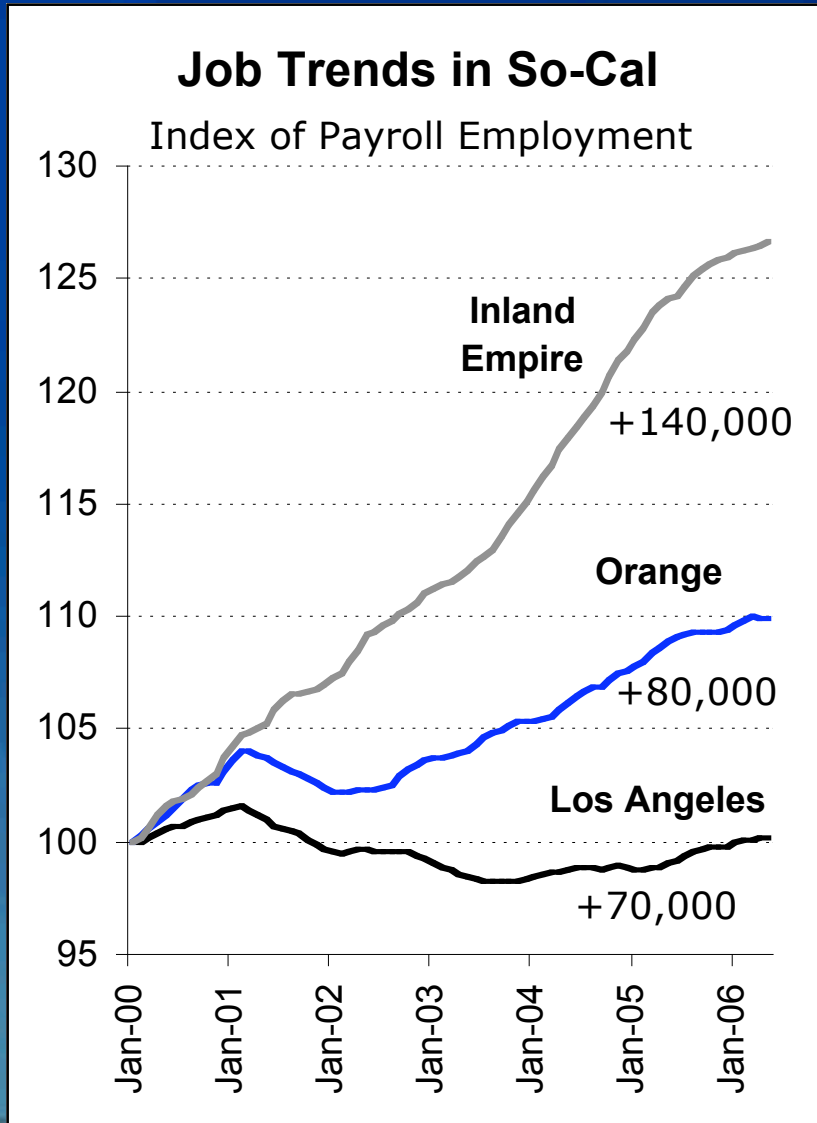
Manufacturing Employment Share by State



California Exports (\$Bil)

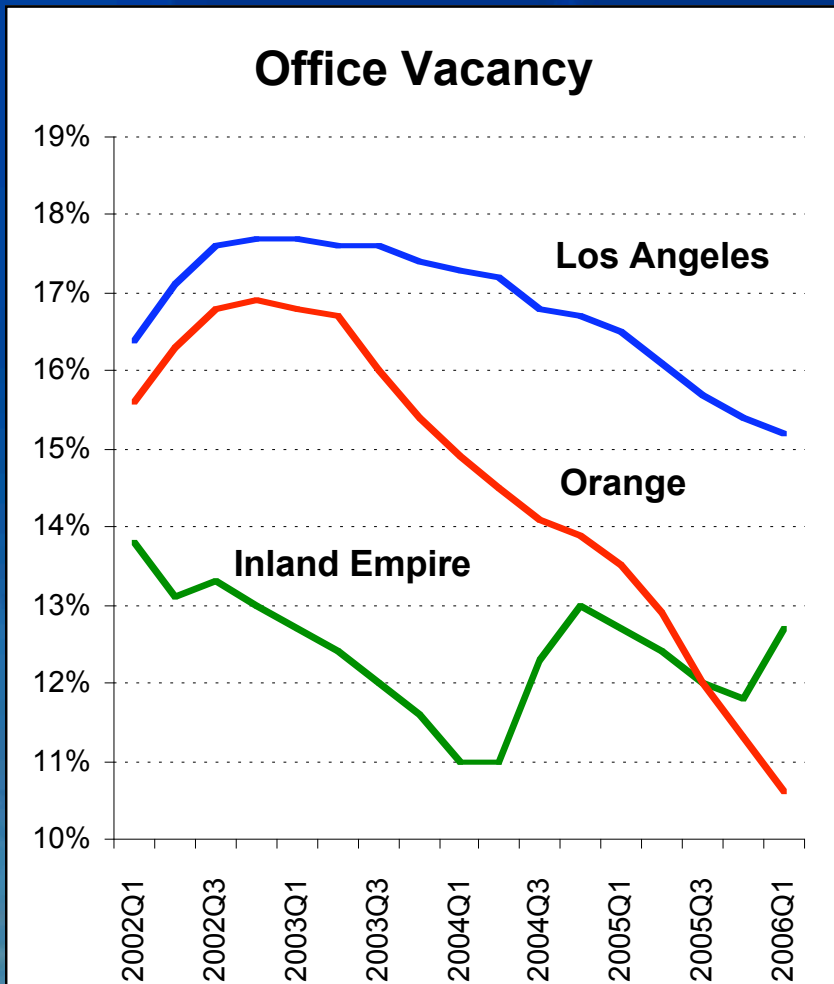


Southern California Jobs

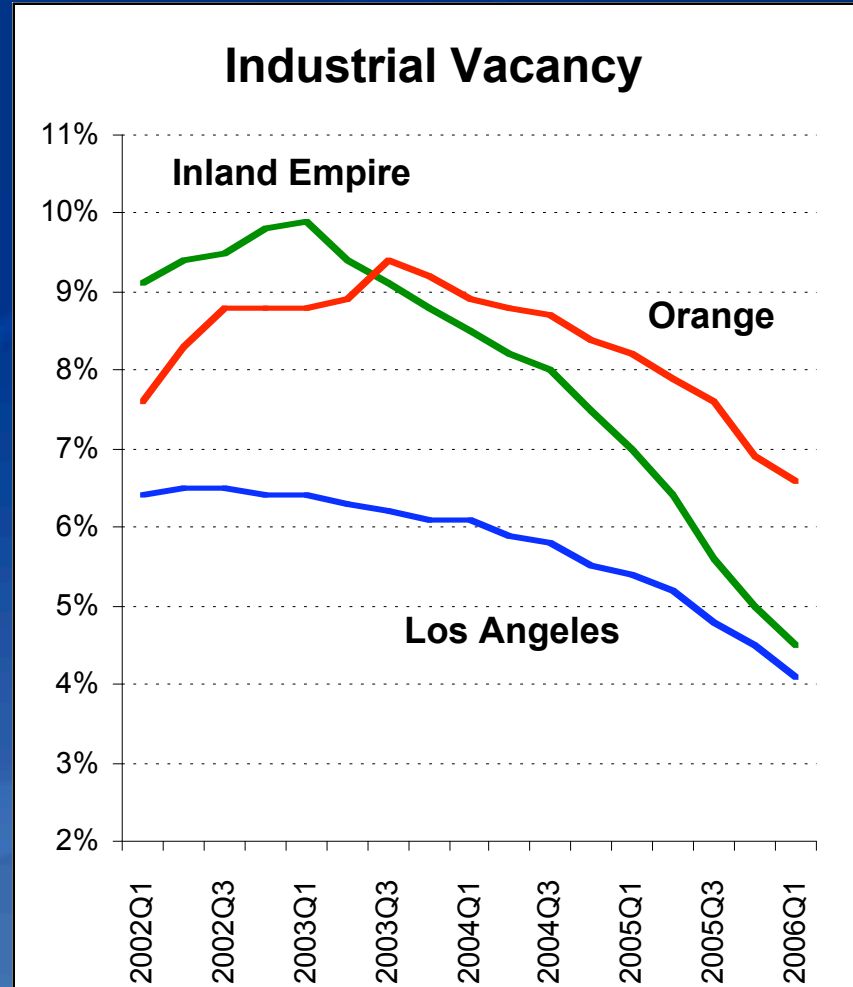


Non-Res Markets Showing Strength

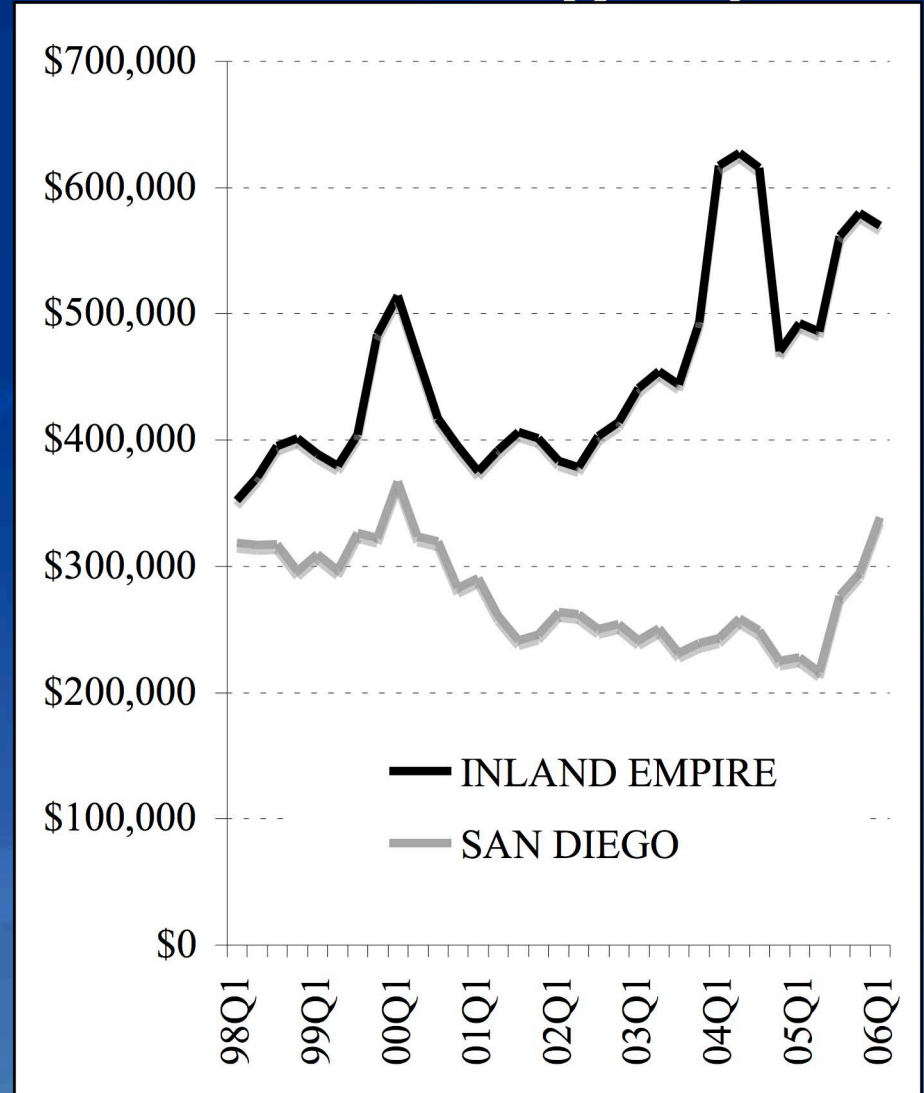
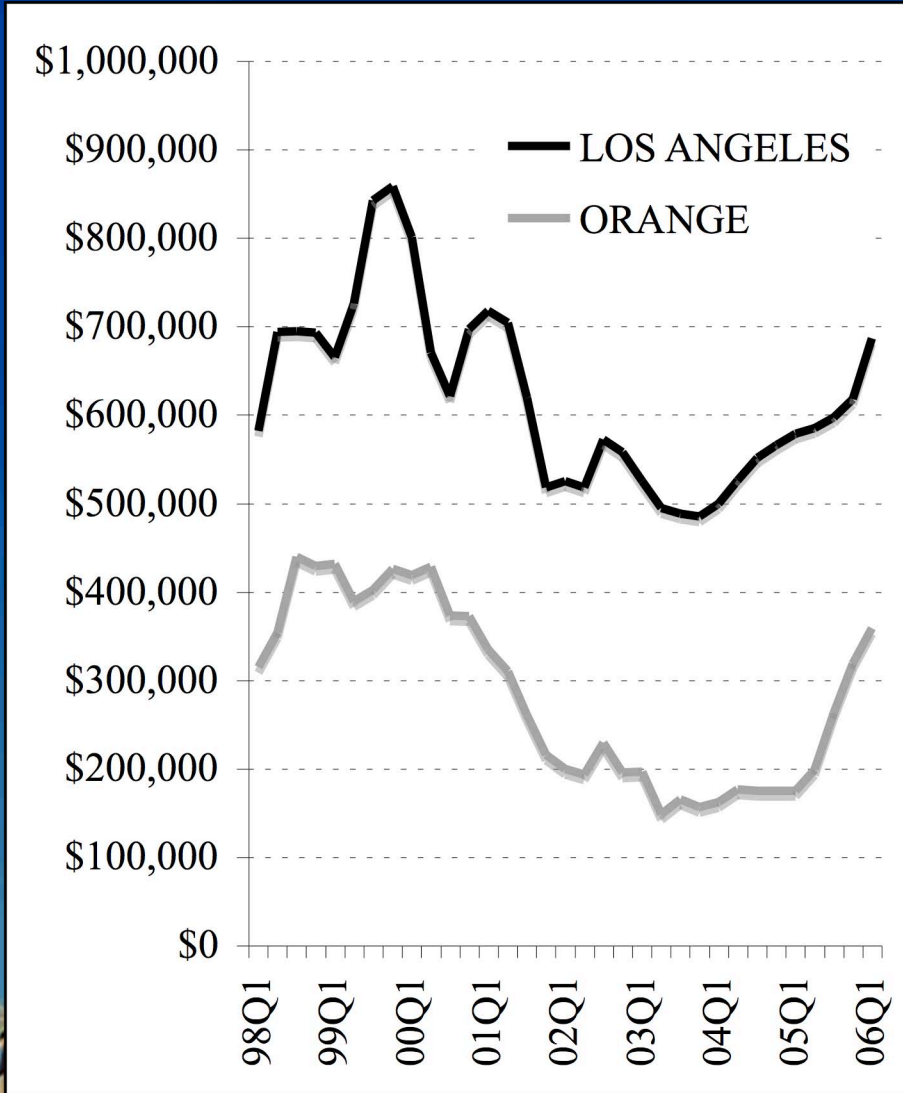
Office Vacancy



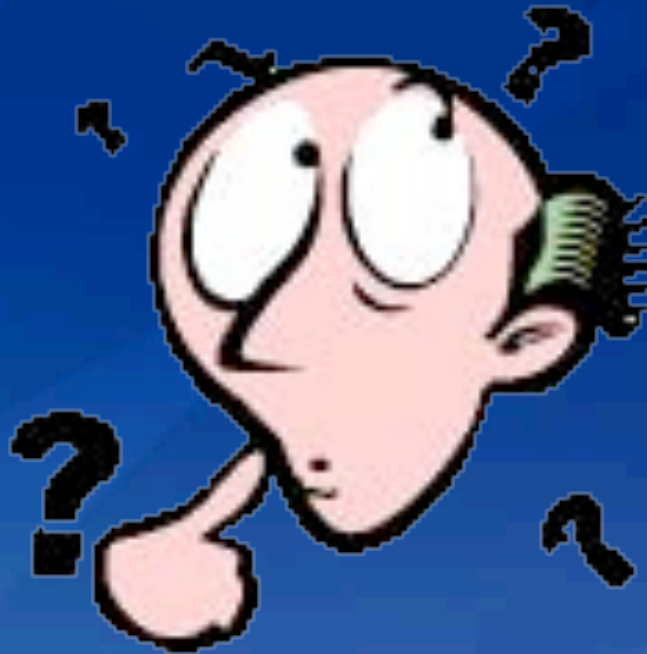
Industrial Vacancy



Non-Res Construction Picking Up

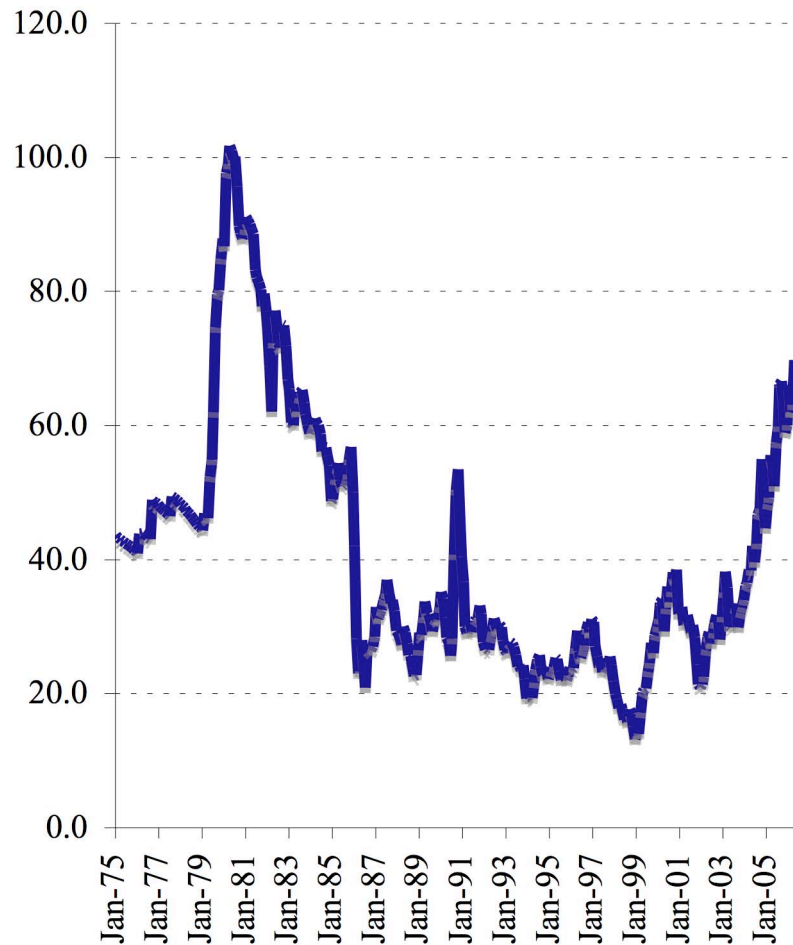


So: what's the problem??

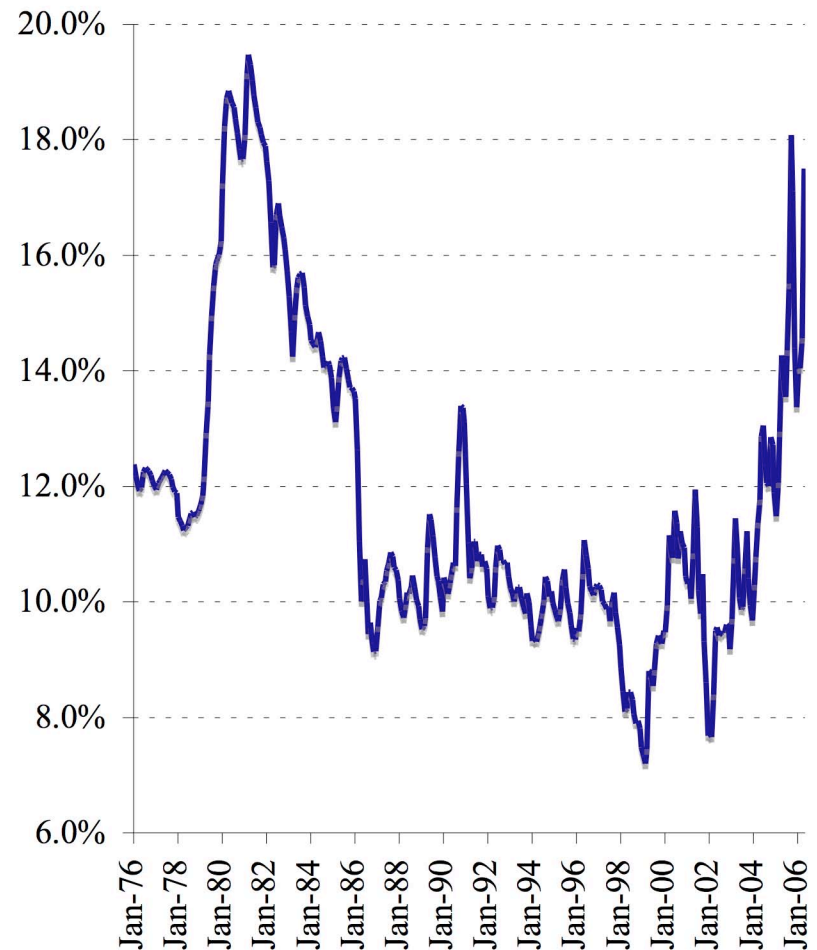


GAS PRICES?

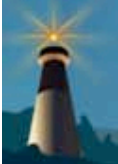
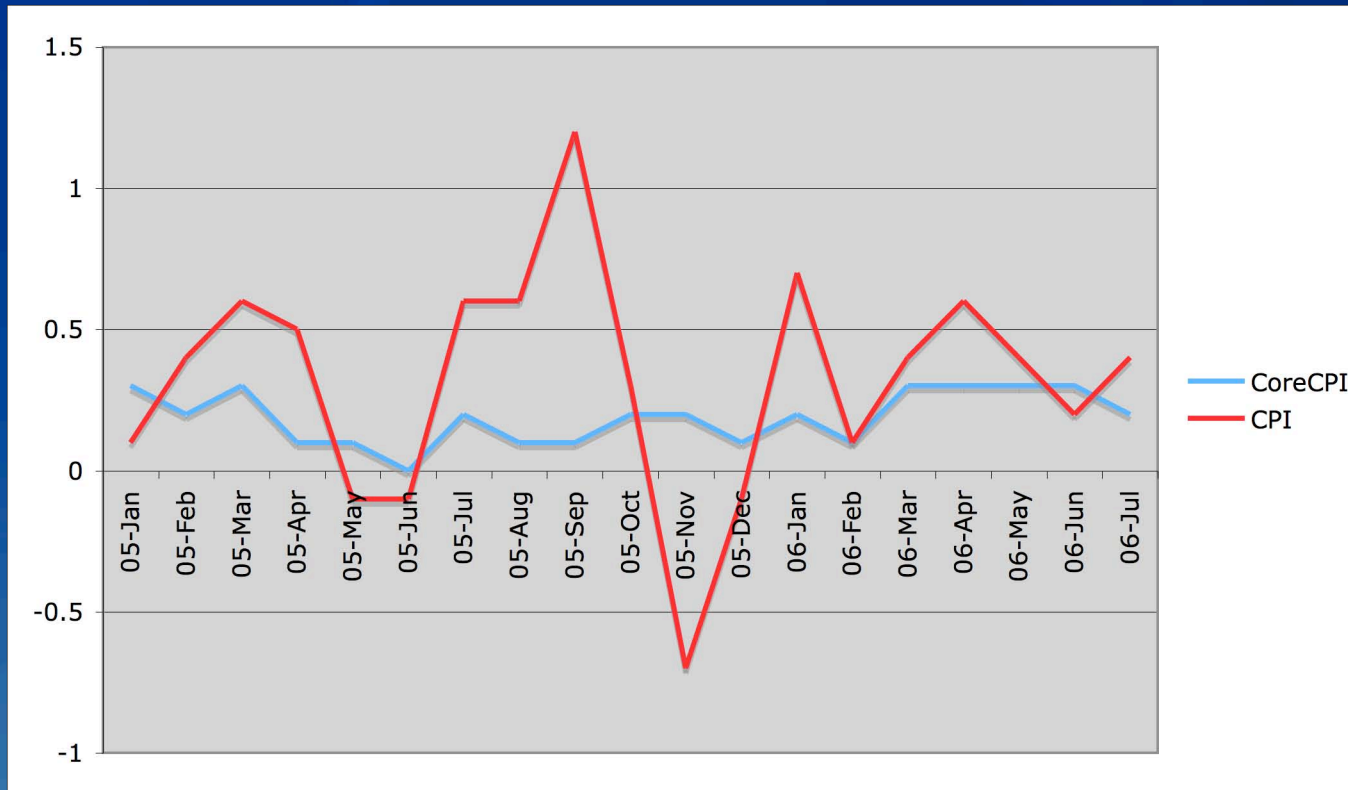
Real Oil Prices (Core CPI Deflated)



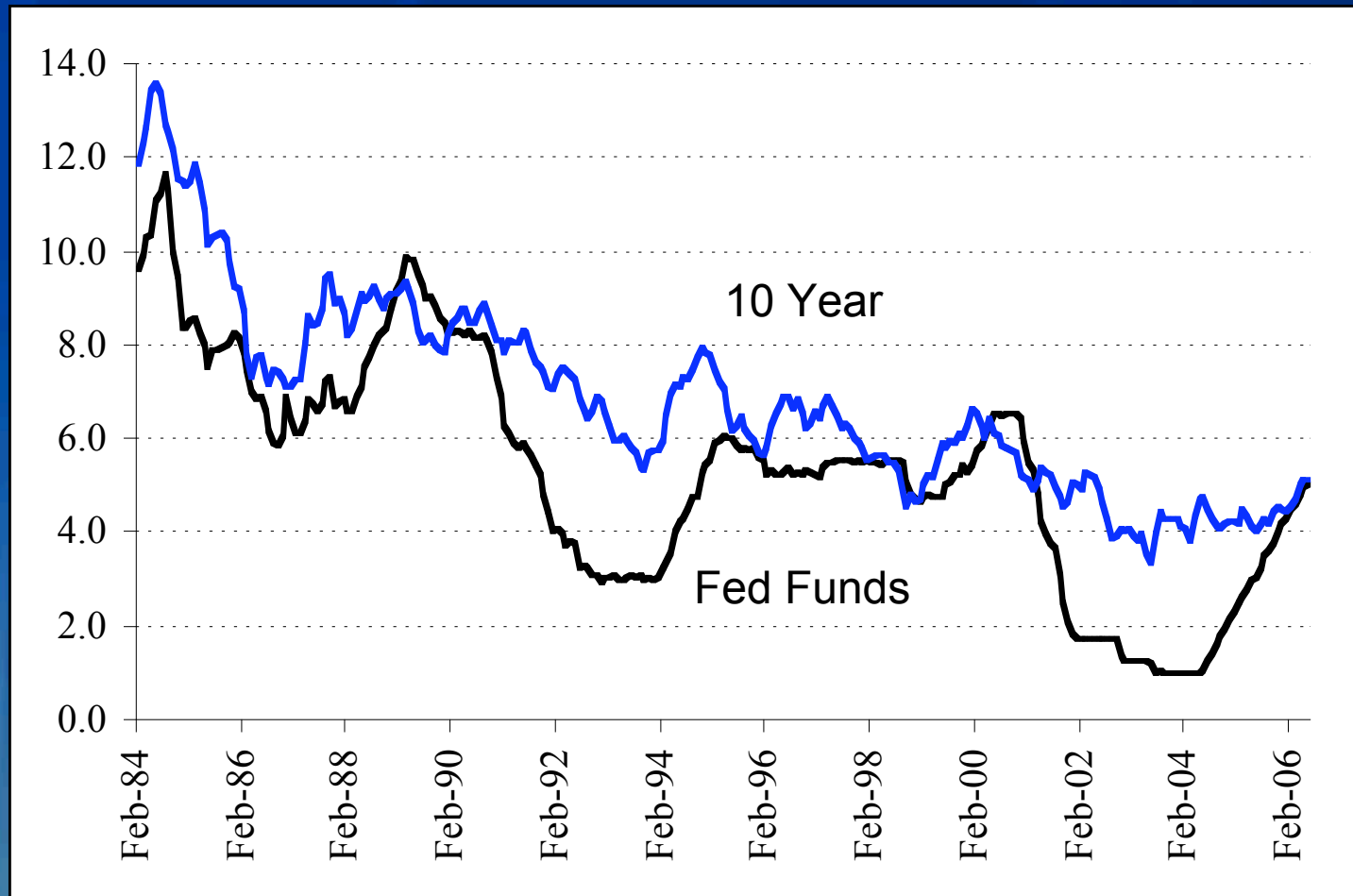
Gasoline / Average Hourly Earnings



Inflation and the Fed

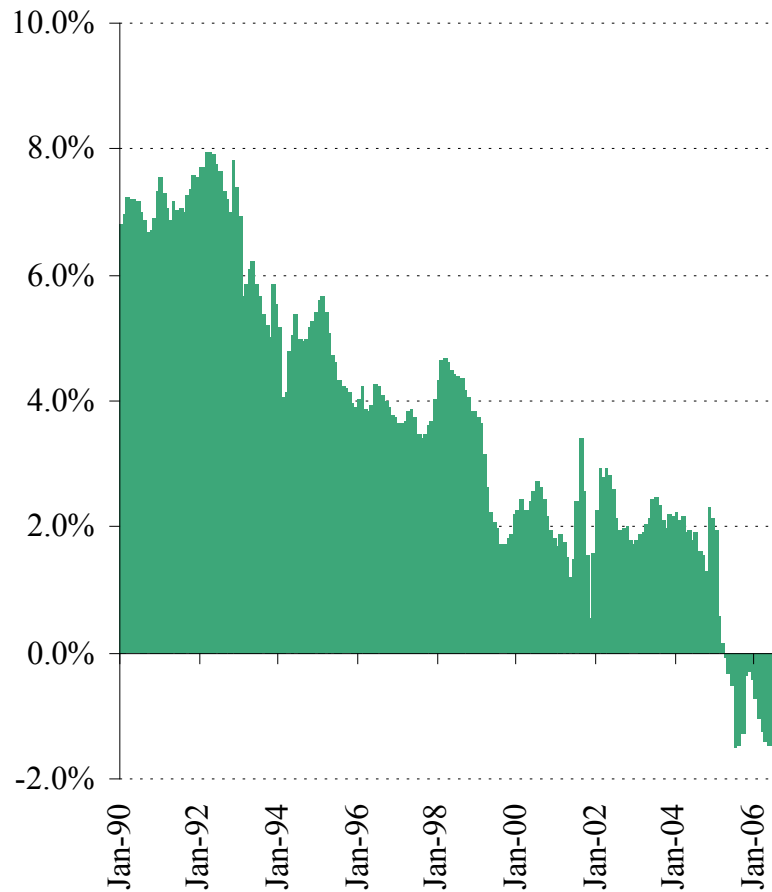


Interest Rates: Still low

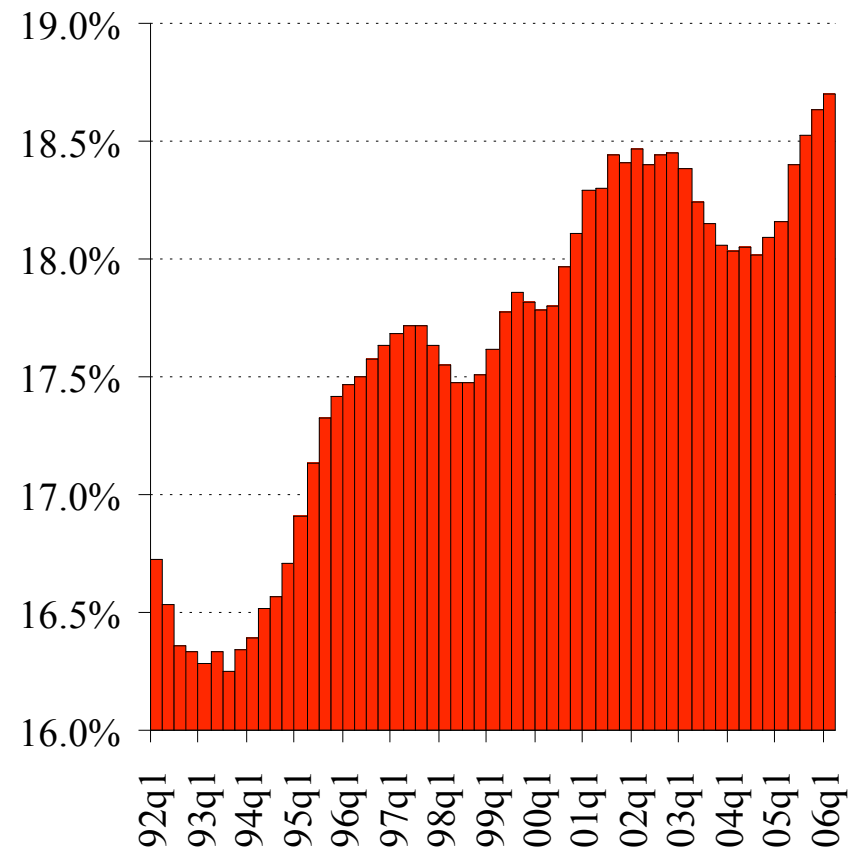


Record high debt, and getting larger

Private Savings Rate

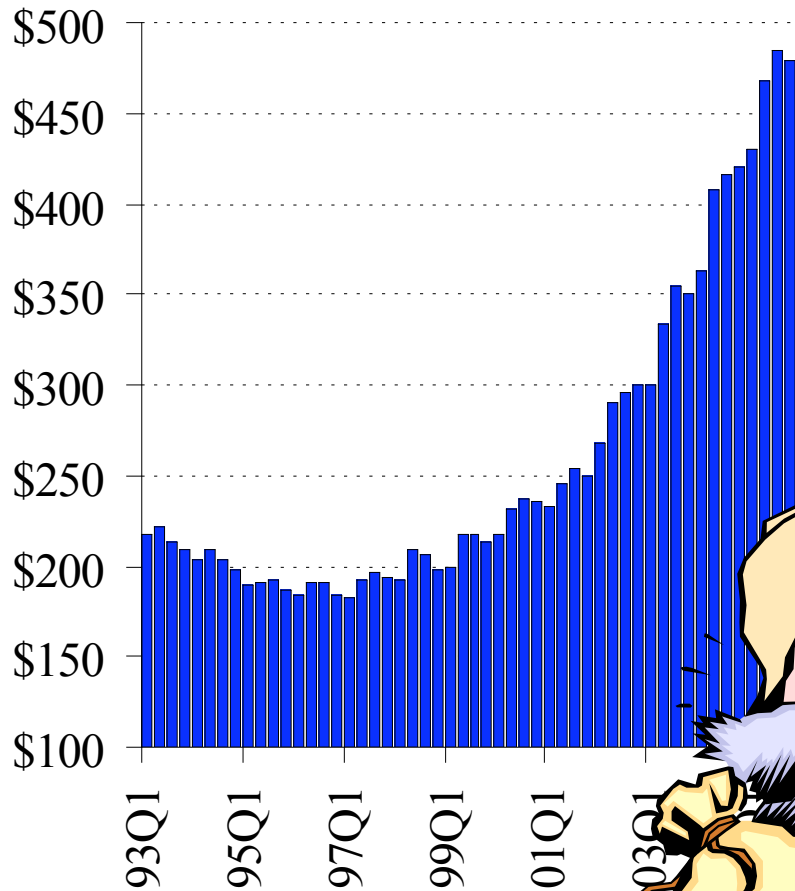


Debt Payments as % of Disposable Income

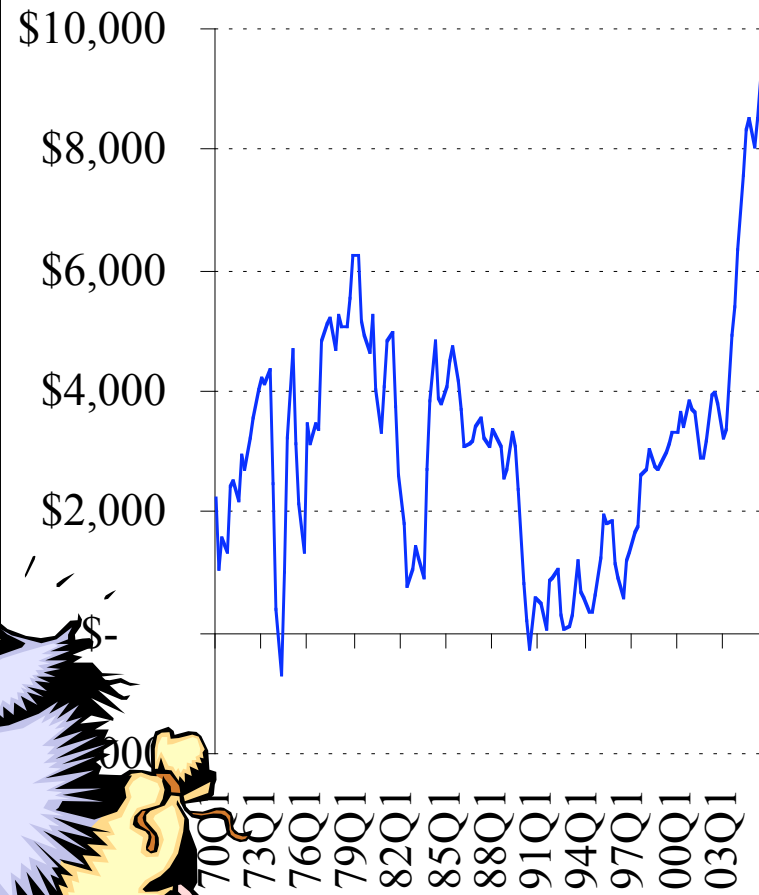


There's gold in them thar timbers!

Real Median Prices

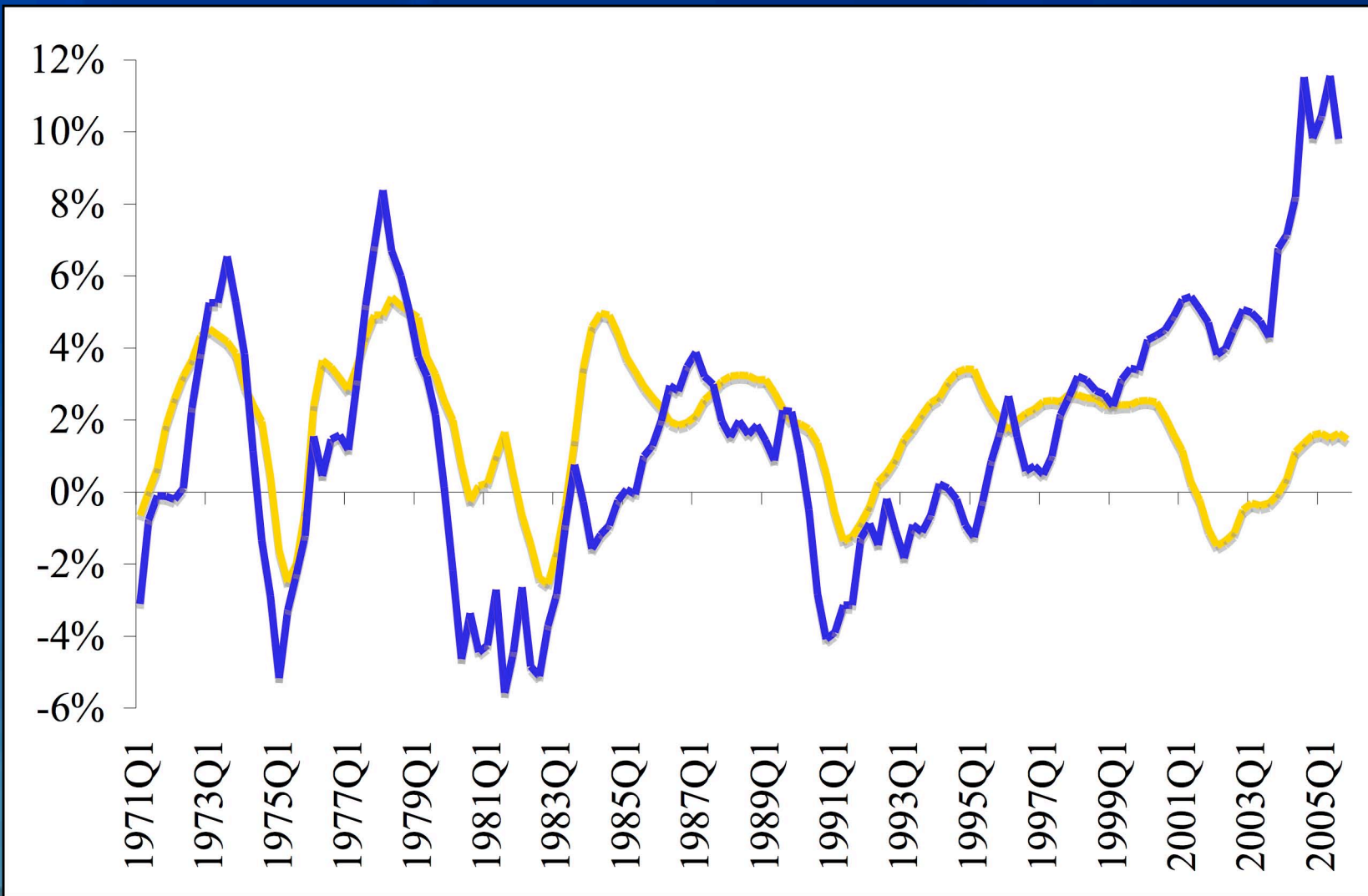


New Housing Wealth per Worker (Real)



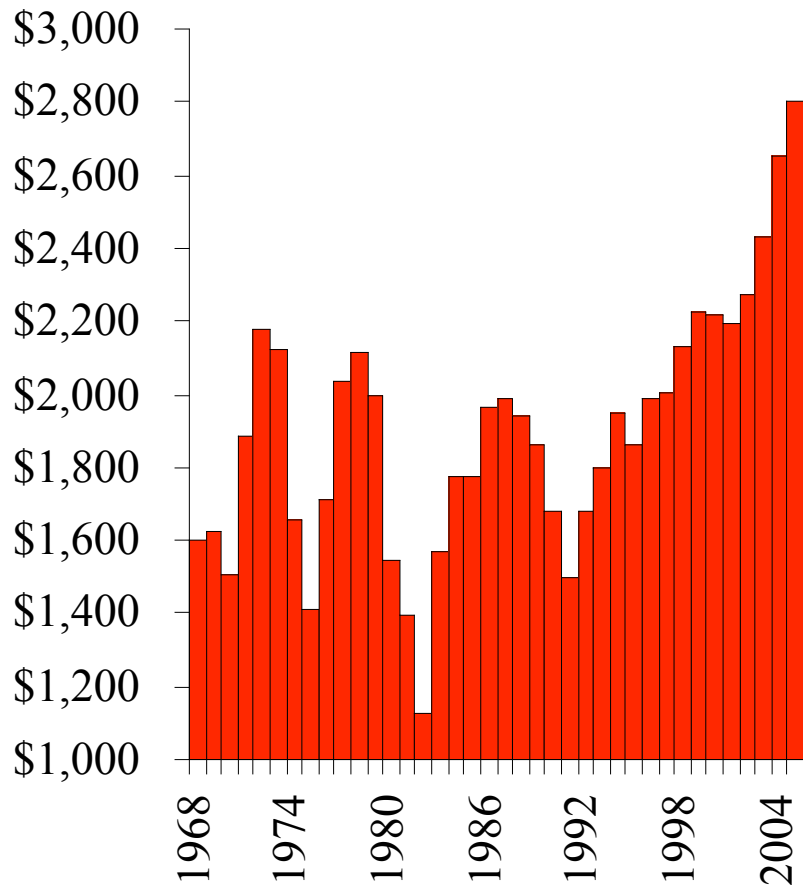
Ah, that bubble thing...

Changes in employment and housing prices

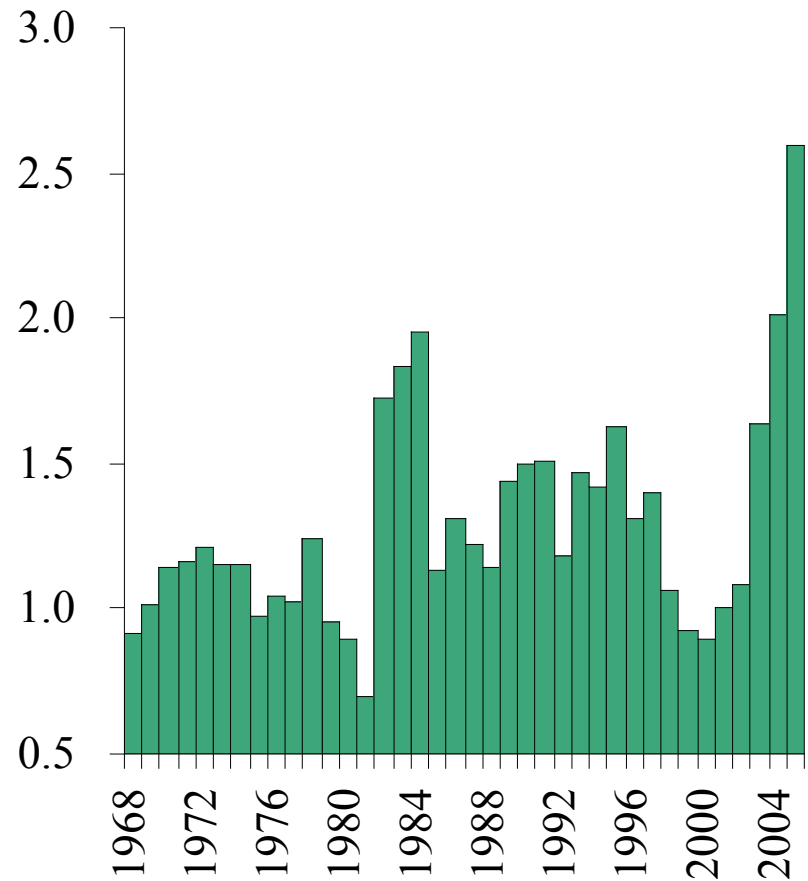


... and Overbuilt

Real Spending Per Adult

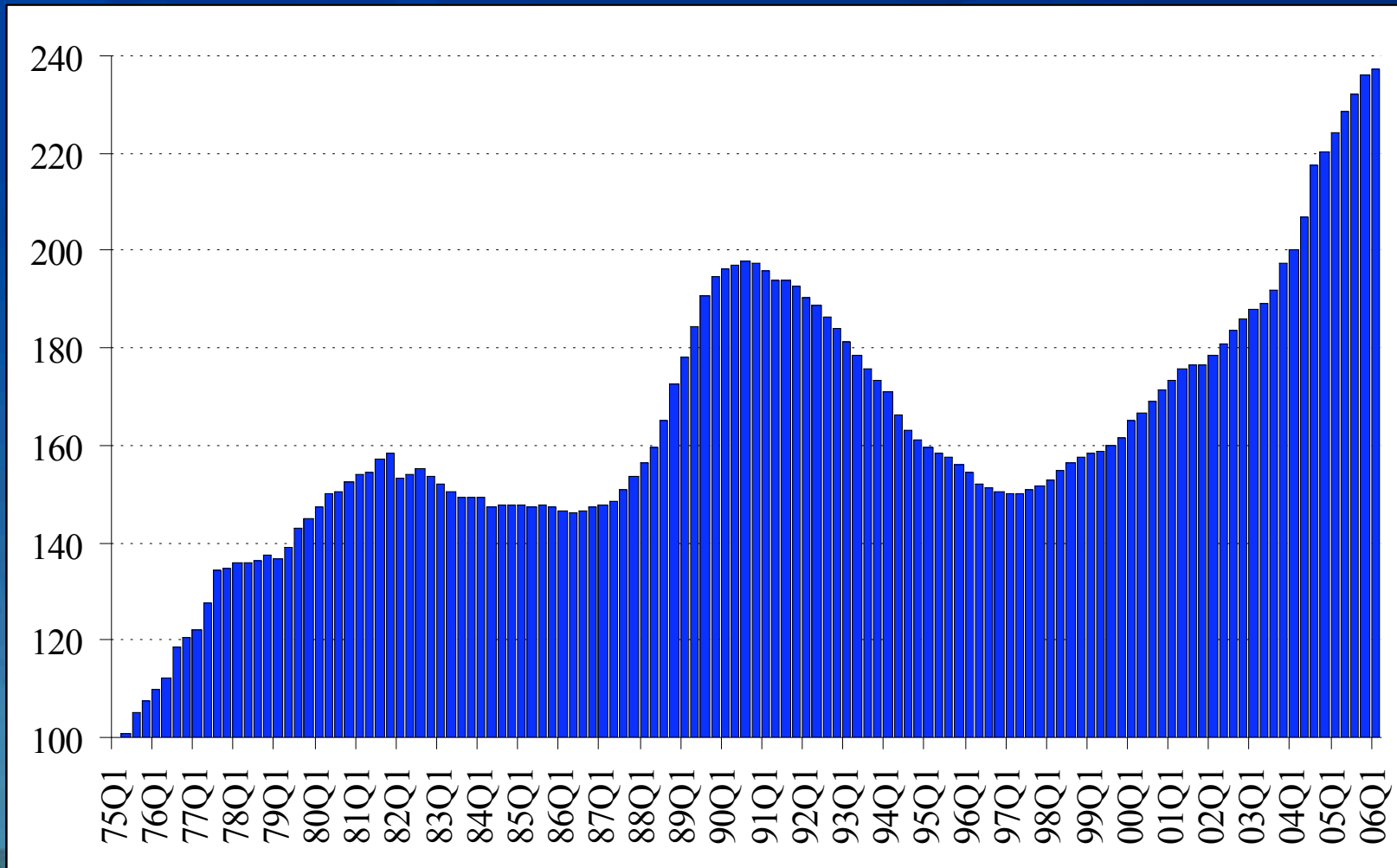


New Units / New Household



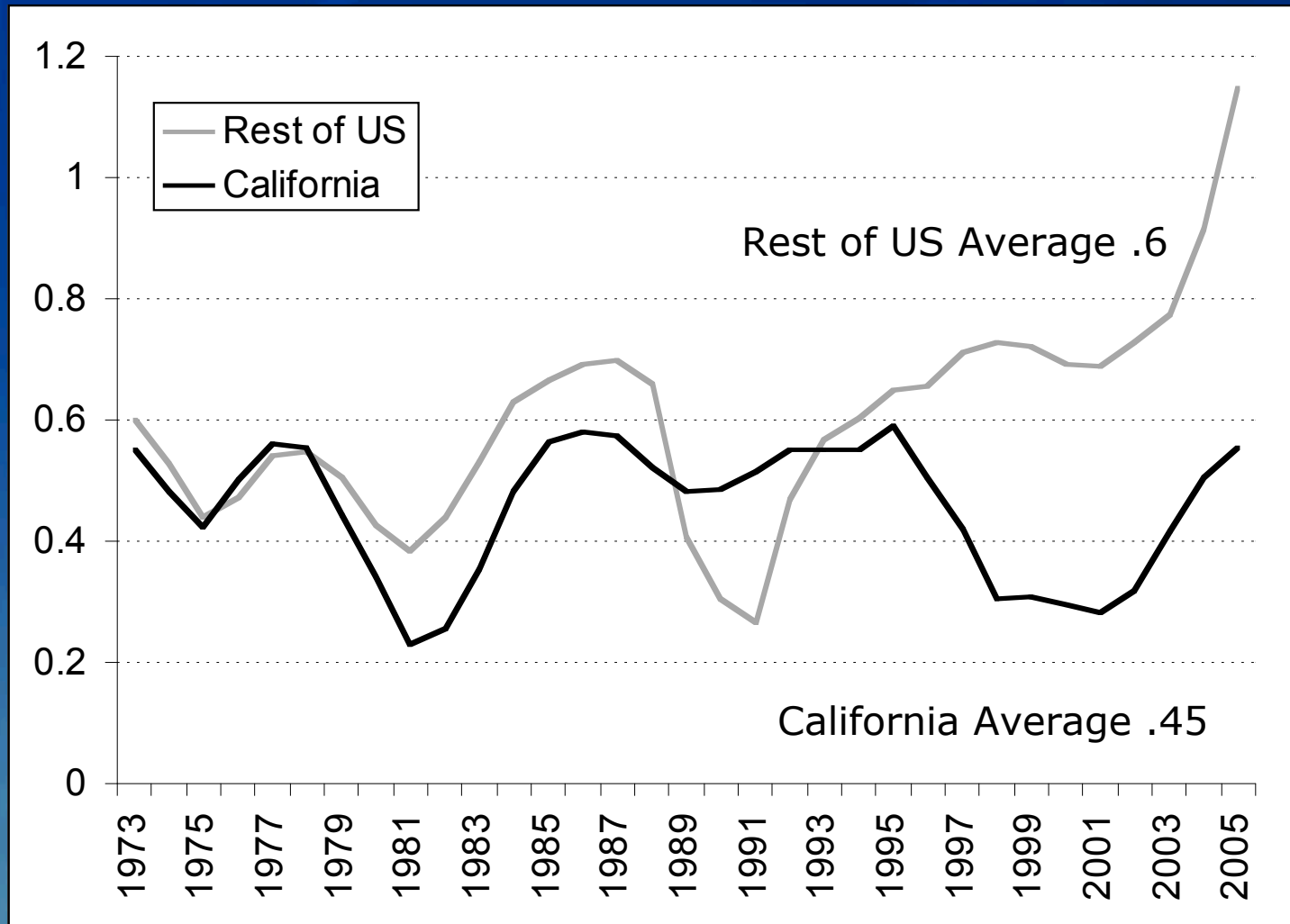
California Housing

Price of California Housing Relative to US Average
Based on OHFEO statistics, 1975Q1 = 100



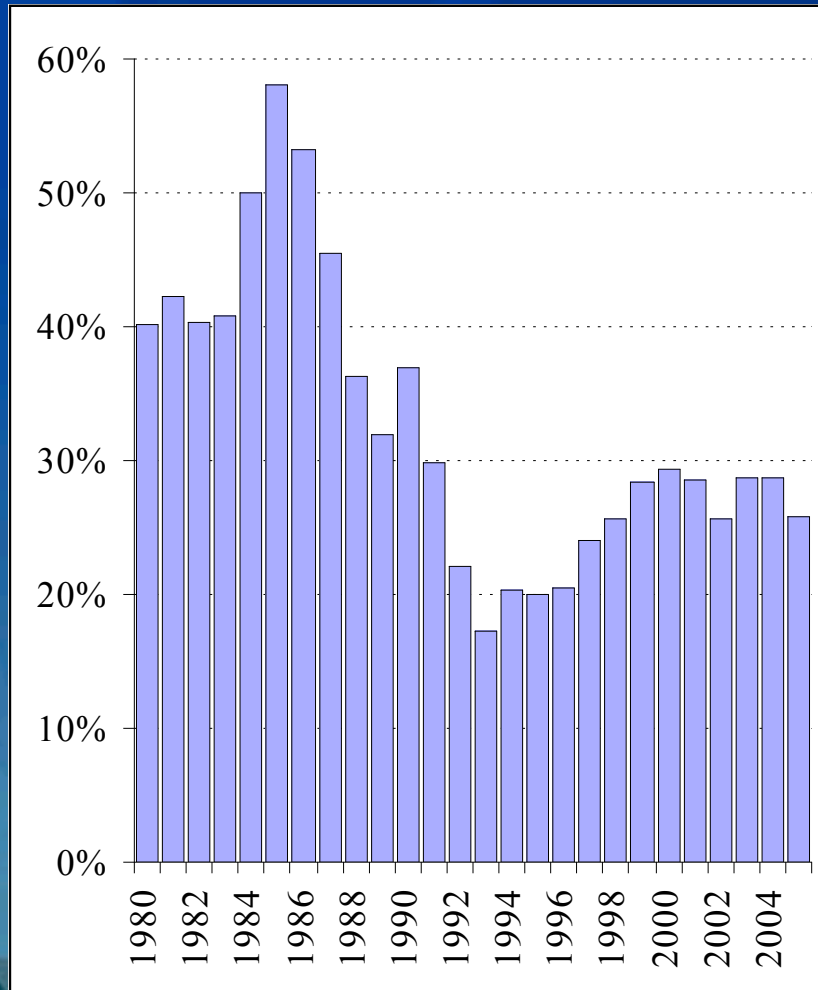
One Part Bubble, One Part Supply

New Housing Starts / New Adults

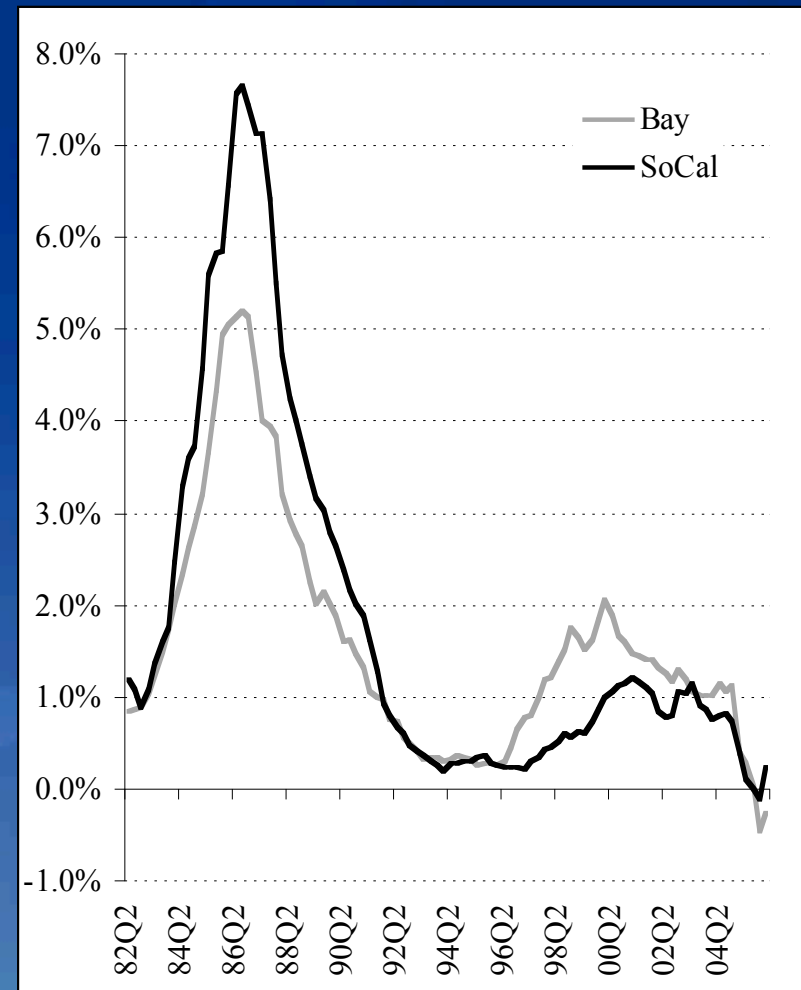


Apartment Stocks

Multifamily as % of New Residential Units



Percent growth in the quantity of rental units (SAAR)



Is it a bubble?

Real Estate is an asset and HAS a fundamental value

Today's price *should be* the present value of the future revenues



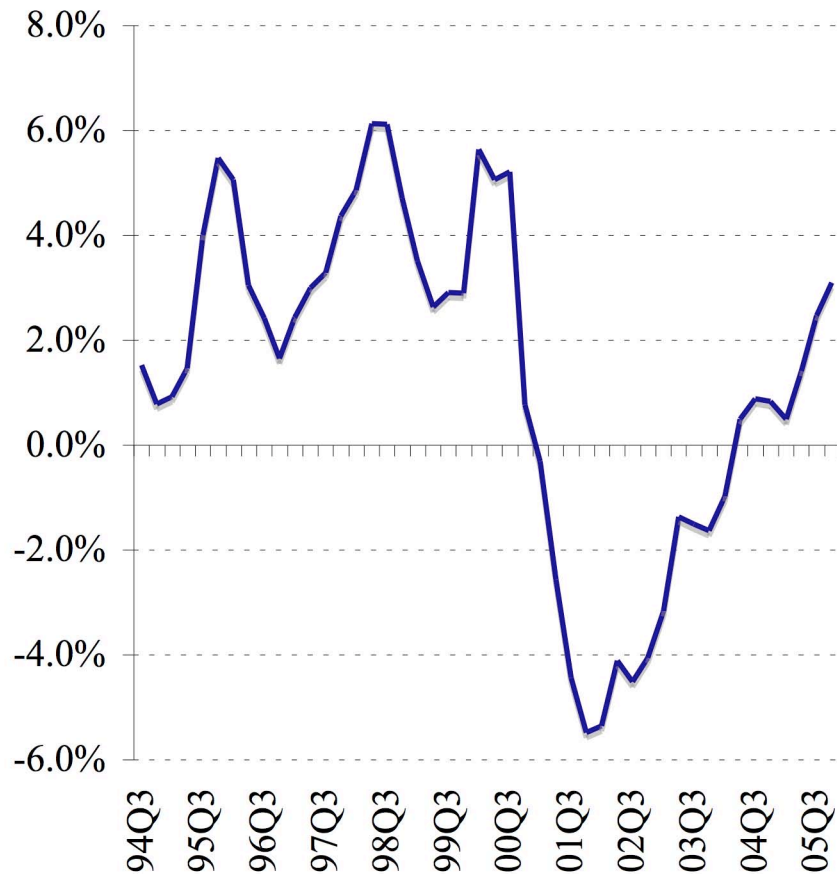
$$\text{Value} \approx \frac{\text{Today's Rent}}{D - G}$$

G: Future rental growth rates

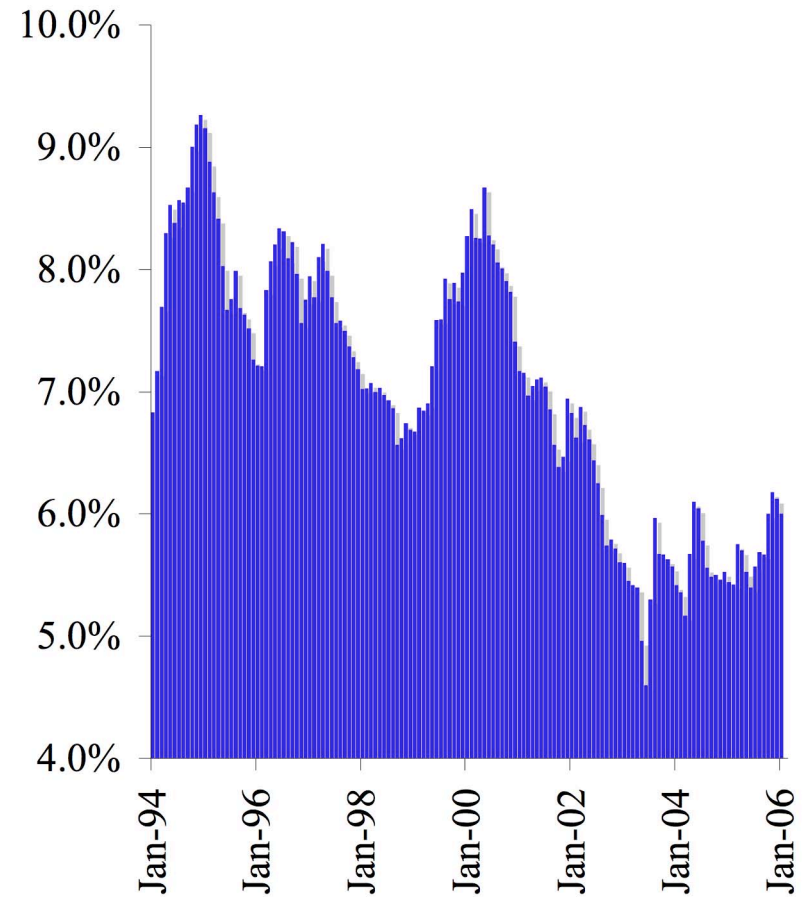
D: Discount factor: mortgage rates, depreciation, taxes, risk premium

Rental growth and mortgage rates

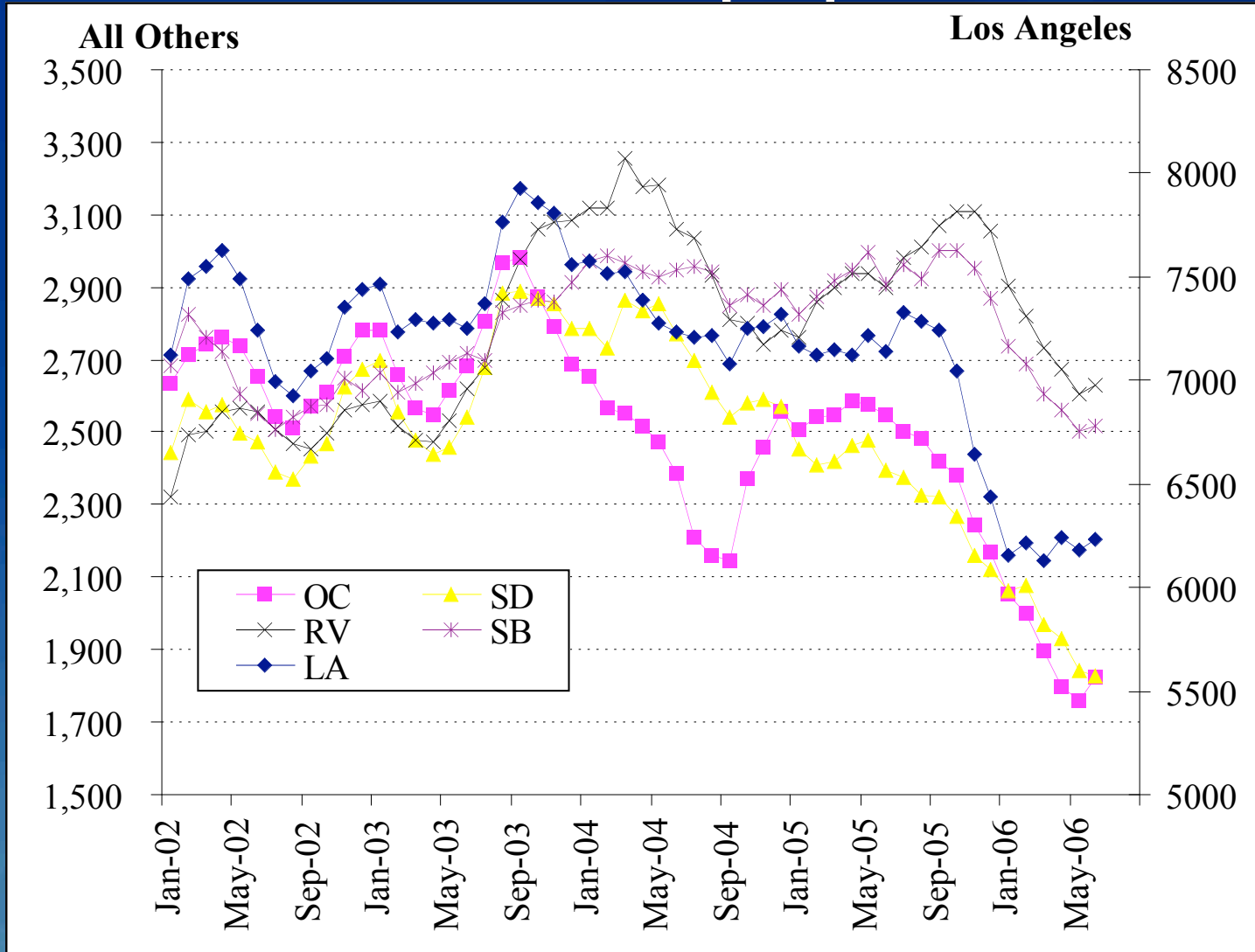
Real US Rental growth



Mortgage Rates (Fixed)

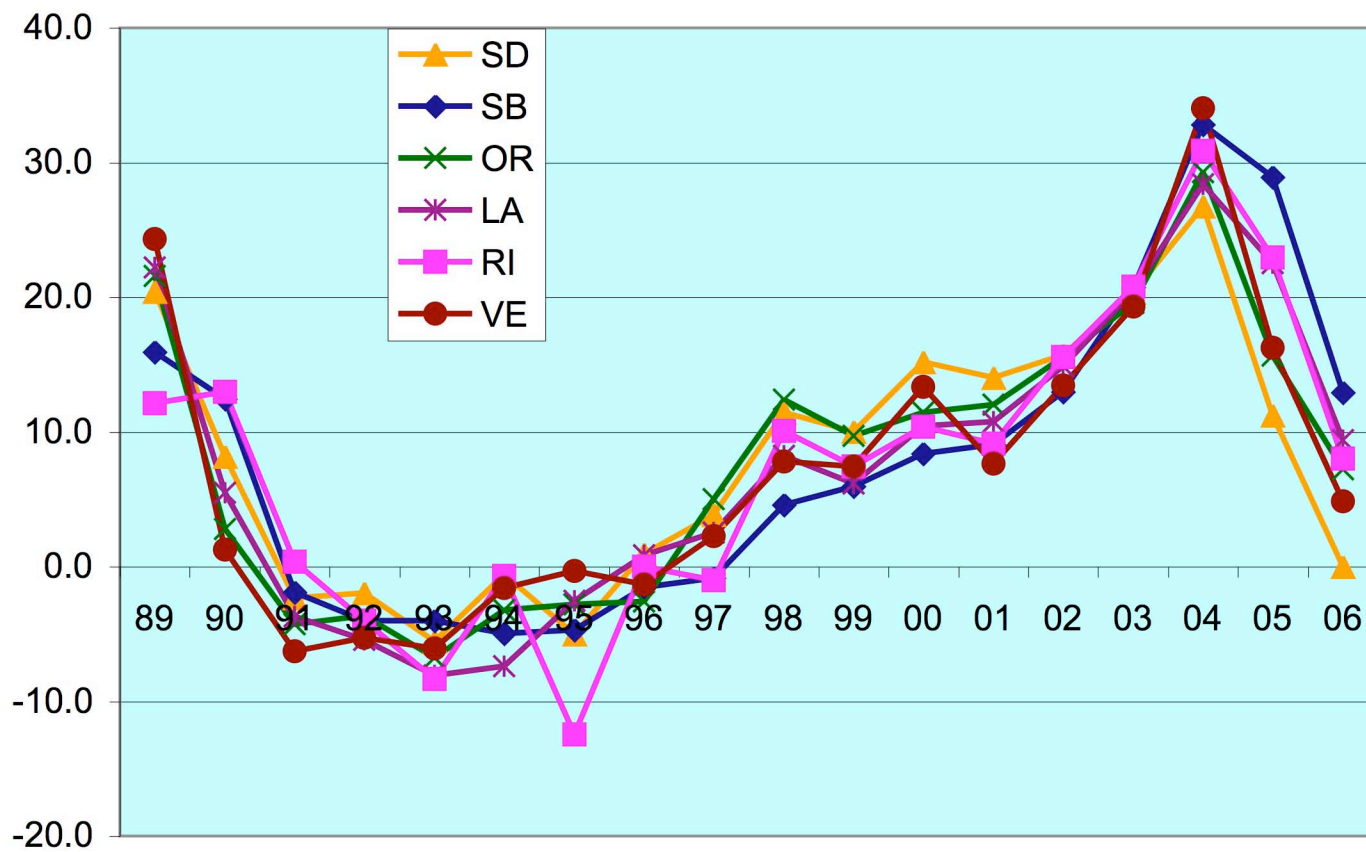


How's the pop?



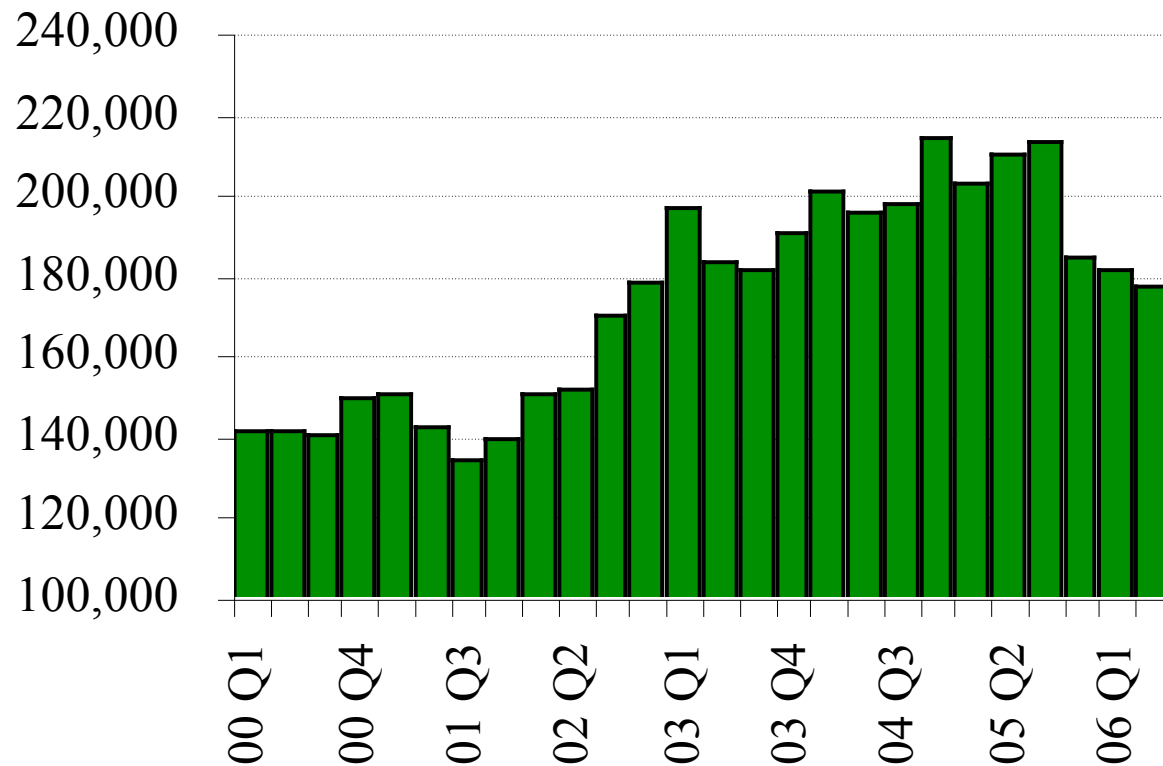
Prices: Flattened

Southern CA GLS Housing Indexes
Annual Percent Change



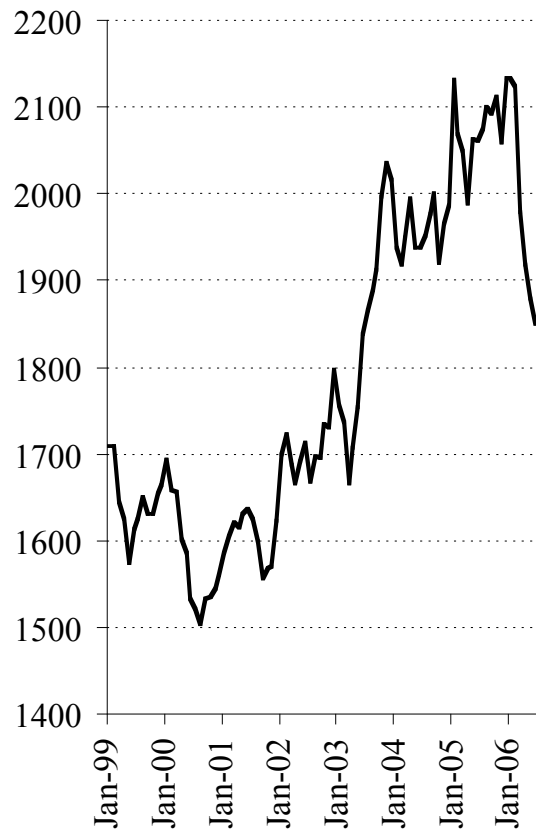
Home Building Slowing

**California Residential Building
Permits, SAAR**

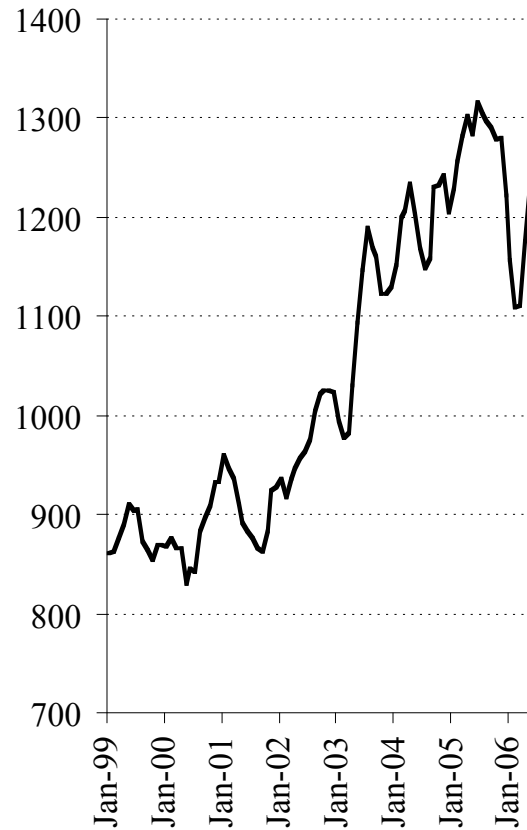


The national picture

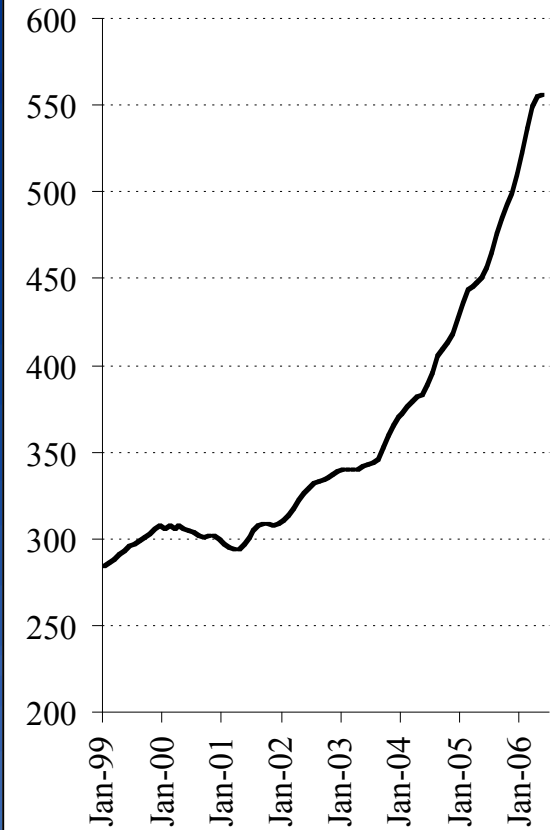
Starts



Sales

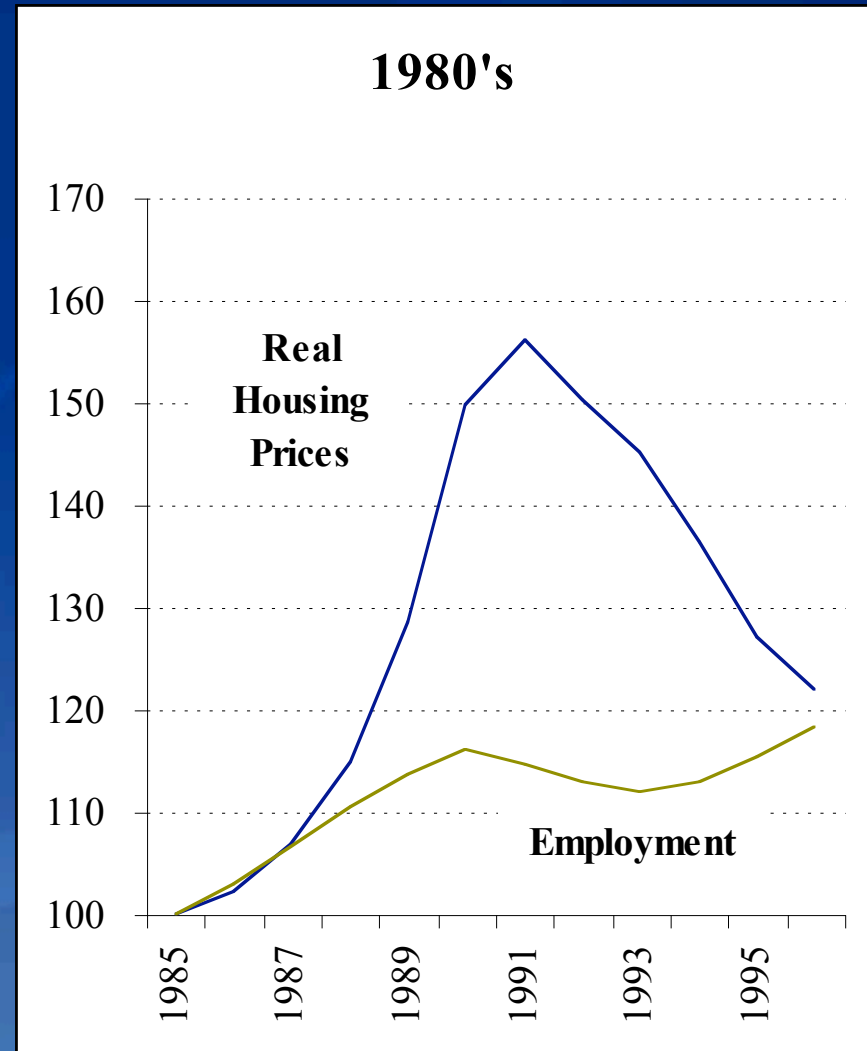
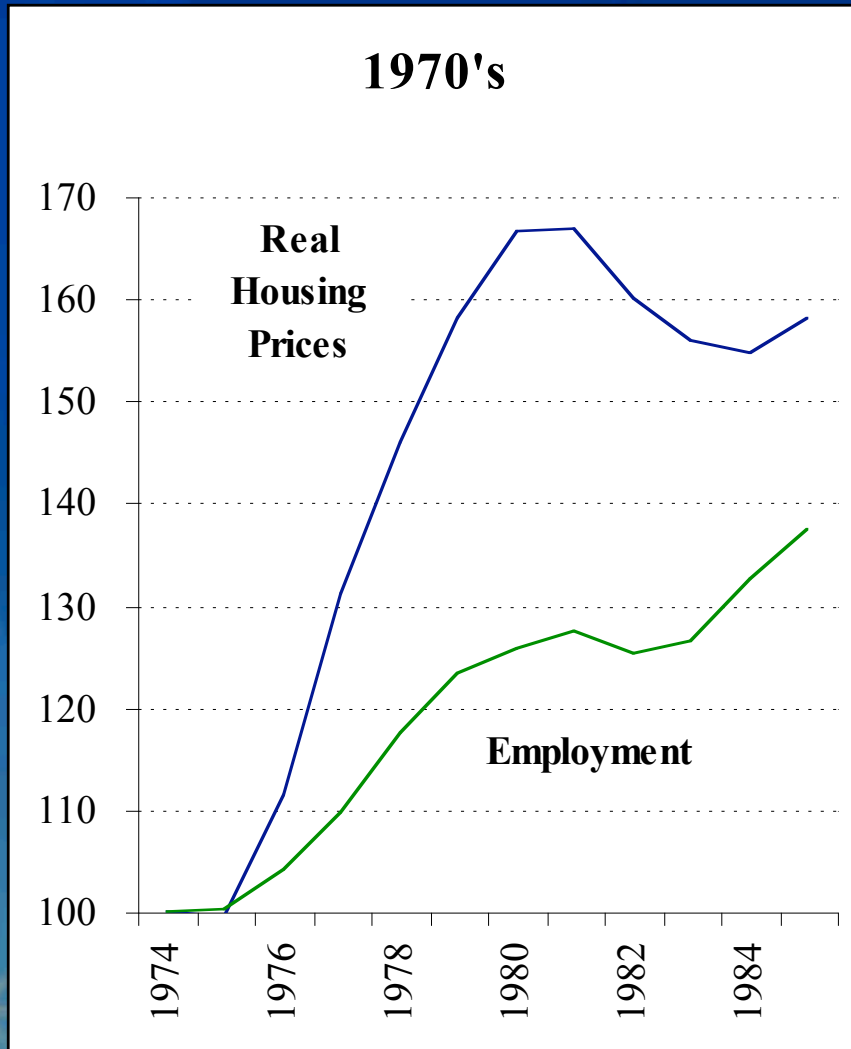


Inventory

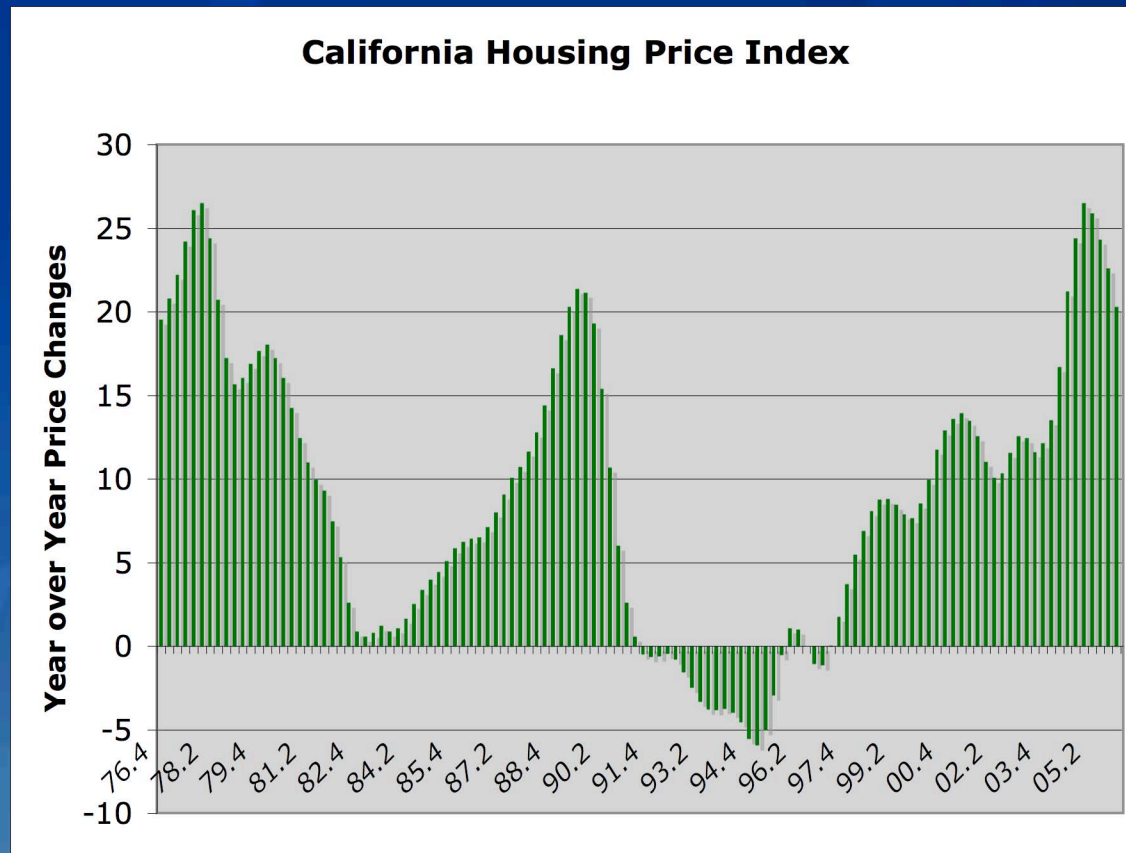


Seasonally Adjusted and Smoothed, 000's

Which 'pop' will it be?



Hard to tell which bubble...

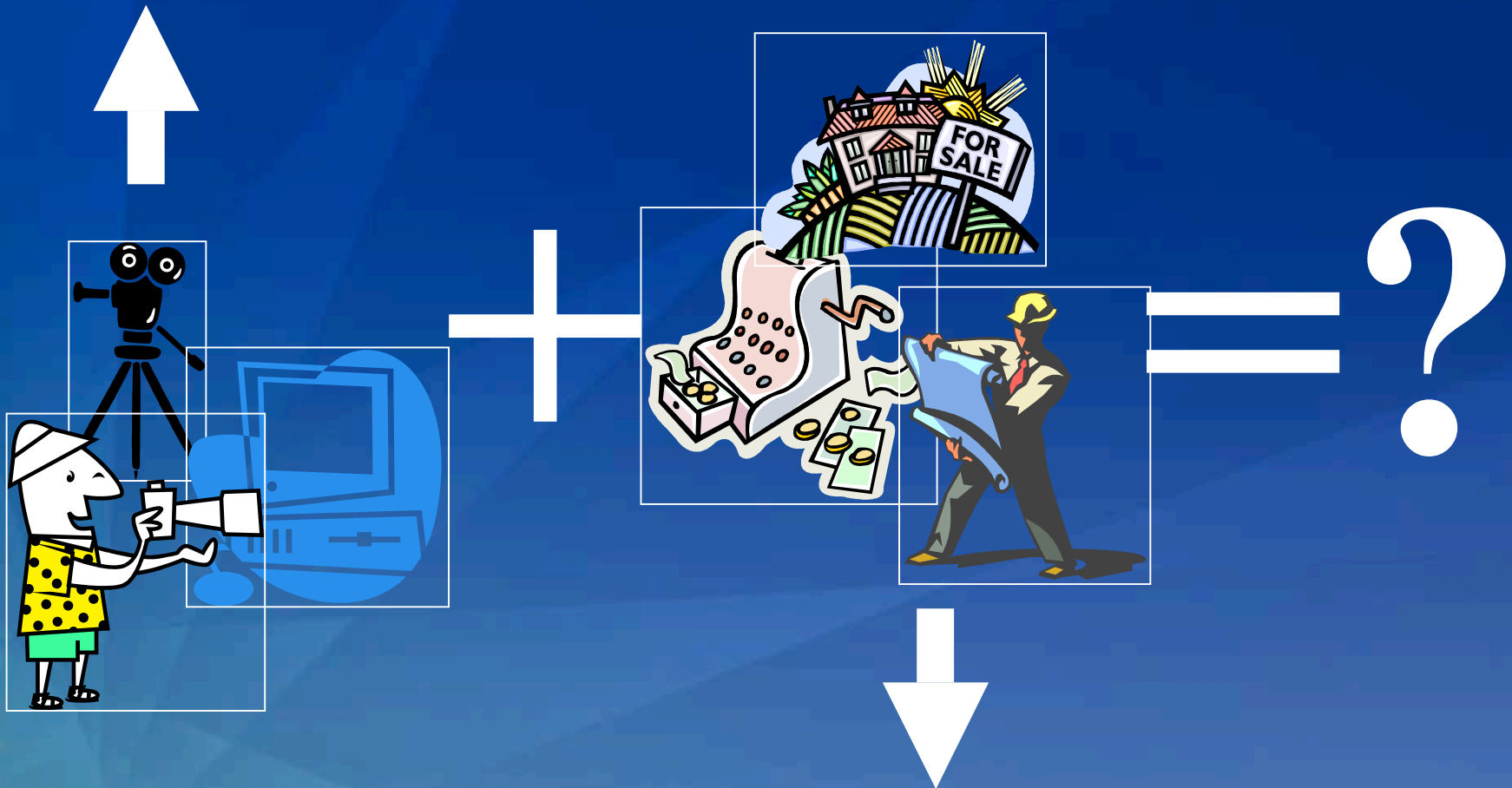


The good news

- Housing is not that big a component of the economy
- The dollar is down
 - Demand for exports is up
 - California is an export oriented state both for goods and services.
- Tourism and Trade in the state solid
- Corporations are sitting on large war-chests
 - Cash in the bank will help them weather future slowness
- Cyclical employment limited by lack of build-up
 - Weak job growth in retail and manufacturing may mean less job growth
 - Without a potential for large job losses, the slowdown in real estate may be gradual enough

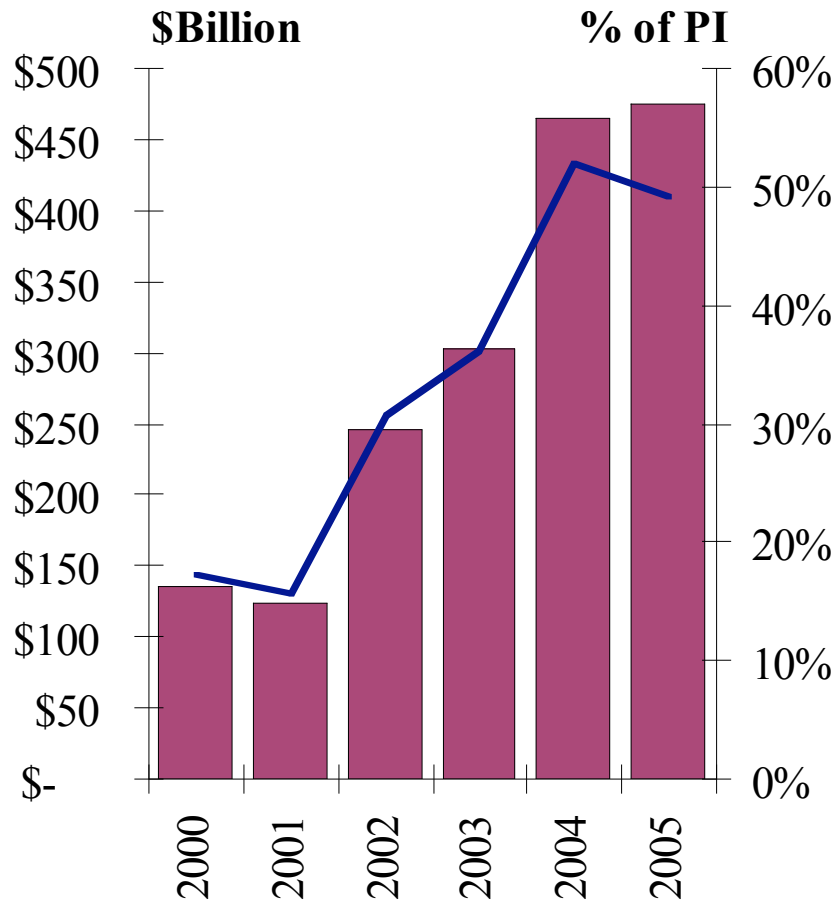


What does it add up to?

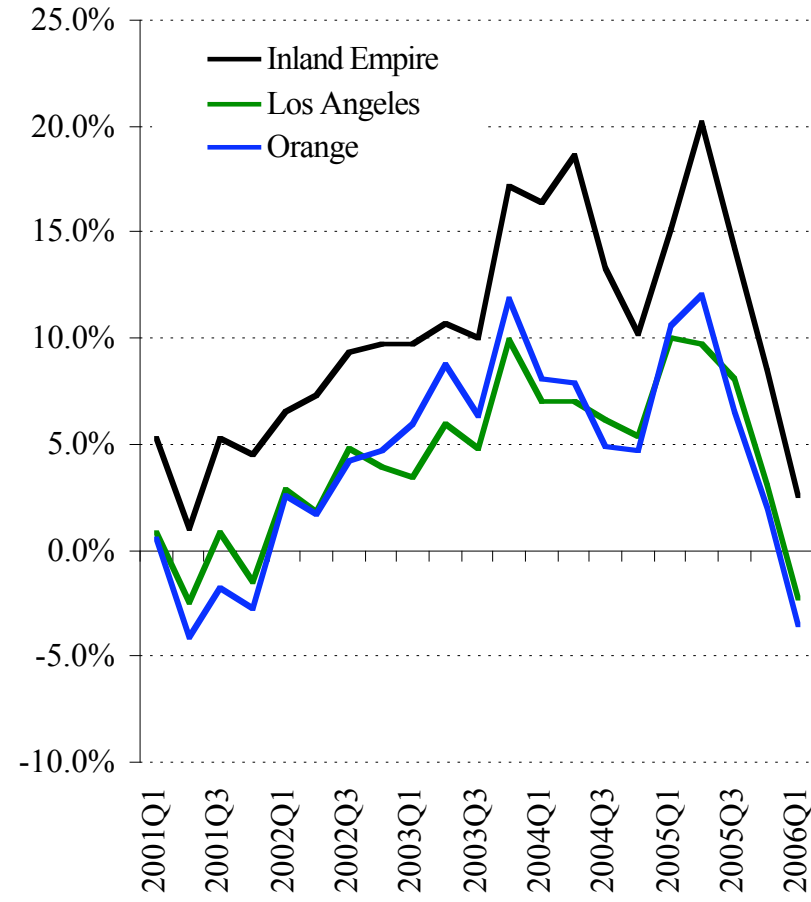


The wild card: the wealth effects

New Housing Wealth

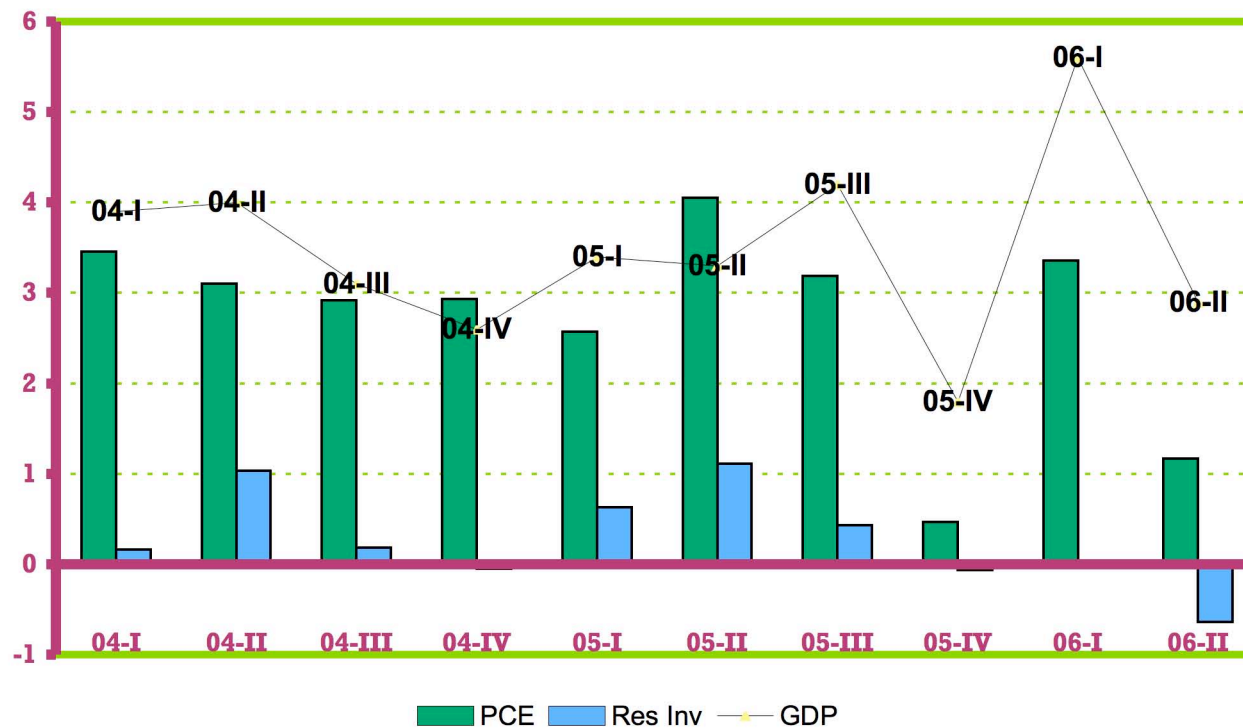


Taxable Sales Growth SAAR



Consumption and Res Const Important for Economy's Continued Success...

Key Components of GDP Growth



What's the Fed to do?

- Interest rates
 - 17 consecutive rate hikes, 1 month hiatus
- Consumer price index
 - Increases driven by rental rates
- Catch-22 wrt further rate hikes
 - Rents, pushing interest rate hikes, pushing housing bubble, burst consumption spending
- We, and the markets expect no Fed to hold tight



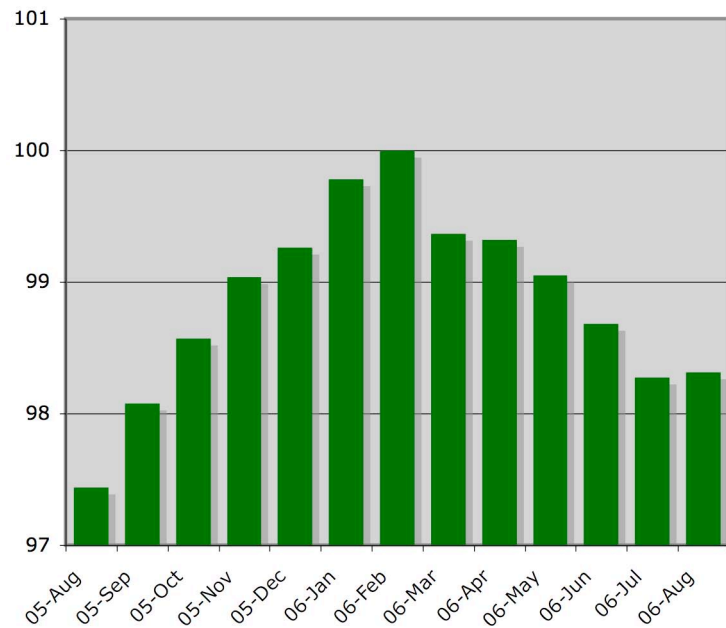
Outlook: A Housing Correction

- Weakness in Housing
 - Housing starts edge down from 200K+ to 125, similar decline in CA
 - Prices to be flat for some time
- Less than Normal Growth at state and national levels
 - Housing Related Job Losses
 - Drag from negative wealth effect
- Market expects significant downturn nationwide in residential construction
- POSSIBILITY OF RECESSION IN THE FORESEABLE FUTURE
 - 2007 is still a mystery...
 - Watch consumer spending

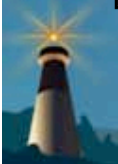
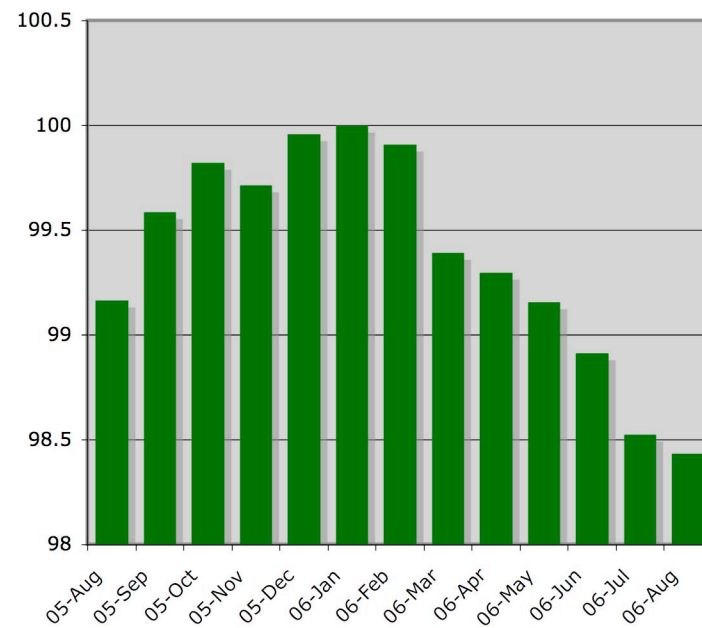


Prospects for CA Residential Const Employment?

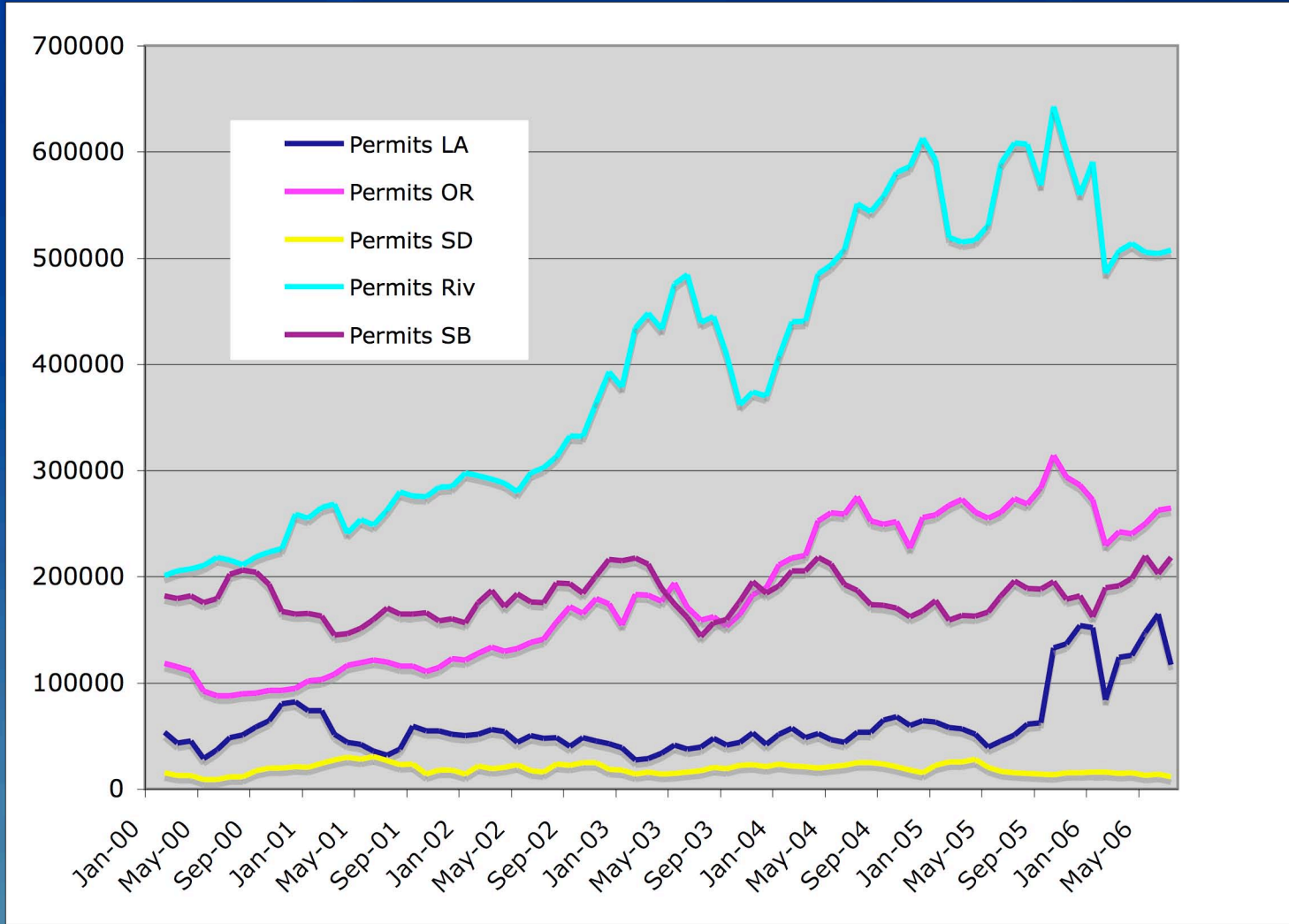
Share of Total US Empl



Share of Total Const Empl

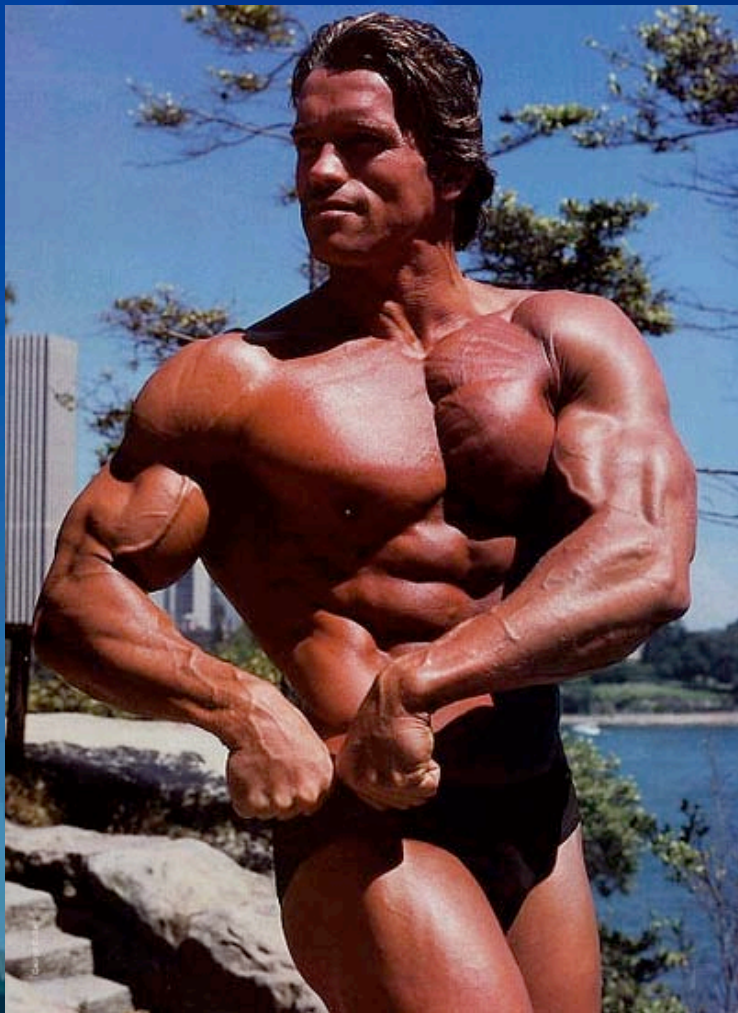


Not Much Optimism from New Permits Issued



Summary of discussion

Had a res-construction economy like this...



...but likely to wind up with one like this.

