



Will the Housing Slowdown Push the Economy into a Recession?

A popular joke tells us that economists have forecast 9 out of the last 5 recessions. Economists always seem to be warning the general public of one risk or another that is supposed to undermine the health of the economy. Over the past few years, the risk most commonly cited by those more pessimistic members of my profession has been the housing market.

Initially, their main concern was the rapid rise of home prices around the country. Some economists firmly believed that the “bubble” would pop—especially in the coastal regions—and home prices would plummet to the pre-boom level. In reality, price appreciation did stop, but any substantial price reductions have been confined to local markets, many of which are in the Midwestern states. Elsewhere, home prices have been more or less flat.

Then their attention shifted to the “mortgage crisis.” By focusing on subprime mortgages, arguably the weakest link in the mortgage market, some economists claimed that mortgage delinquencies and foreclosures would crush any housing-sector recovery.

Three ways the housing market influences the economy.

There is no doubt that the housing market is going through a correction, and how this correction unfolds will influence the course of the economy in coming quarters. Fortunately, the correction to date has been more gradual and orderly than most people expected.

The housing sector affects the general economy mainly through: 1) residential investment, 2) construction employment, and 3) wealth effect on consumer spending. It is worthwhile to examine whether any of these factors can be a cause for the next recession.

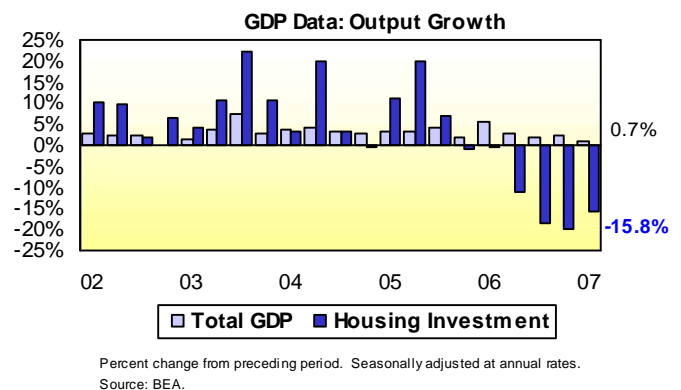
Real GDP Growth (% Annualized)			
	1Q07	4Q06	2006 Annual
Total GDP	0.7	2.5	3.3
Consumer Spending	4.2	4.2	3.2
Business Investment	2.6	-3.1	7.3
Housing Investment	-15.8	-19.8	-4.2
Exports	0.7	10.6	8.9
Imports	5.5	-2.6	5.8
Government Purchases	1.0	3.4	2.1

Source: Bureau of Economic Analysis (BEA).

First, let’s consider investment. Housing investment occurs in two ways: new home construction, and remodeling and upgrading of existing properties. The first quarter real

Gross Domestic Product (GDP) growth was 0.7%. (See the table on the left.) The housing slowdown was one of the factors that made total GDP growth so sluggish, despite a healthy increase of consumer spending (+4.2%), which accounts for 70% of GDP.

Weak residential investment subtracted almost one percentage point from overall GDP growth in the first quarter. The drag from the housing sector, however, lessened to -15.8% from -19.8% in the fourth quarter of last year. (See the chart below.)



According to the Census Bureau, the number of housing units being constructed across the country dropped 24.2% on a year-over-year basis as of May. Even though the housing starts data is about the number of units and the GDP data is concerned about the sum of investment, these figures are generally consistent with each other.

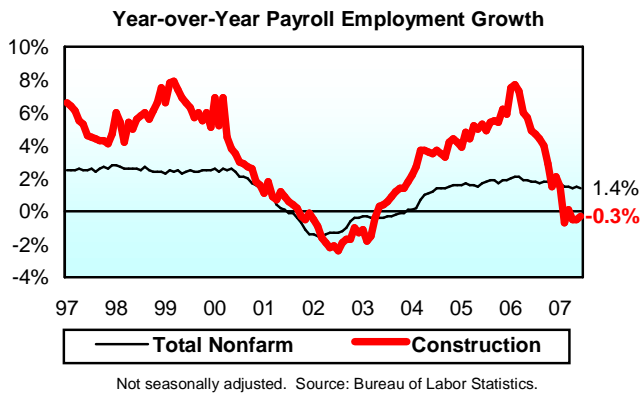
The GDP number looks a little better, because it includes investment in existing properties as well. Work related to existing homes has picked up lately, because sellers now have to upgrade their properties substantially in order to attract buyers. In many markets, extensive “staging” of listed properties—such as kitchen upgrades—has become a norm. We’re not talking about just a new coat of paint or a few rented potted palms anymore.

Housing weakness is offset by commercial construction.

The abovementioned housing starts data would make us believe that construction employment is also falling rapidly. In reality, however, the number of construction jobs has remained stable.

As the chart on the next page shows, the year-over-year change in construction employment was negative 0.3% in June. The building industry is no longer contributing to

overall employment growth (as it did in 2003 through 2006), but at least the nation is not losing too many construction jobs.



If the number of new housing units being constructed has dropped more than 20%, how can construction employment be stable? There seem to be a few plausible explanations.

First, commercial construction activities have increased as economic expansion has boosted demand for office and industrial spaces. Second, new homes are still being built, albeit at a slower pace, because some local markets are healthy, and, even in weak markets, homebuilders are rushing to complete unfinished projects. Third, some residential contractors are now remodeling, repairing, and expanding existing homes.

Wealth effect from home equity is long-lasting.

Finally, let's see whether the housing slowdown has adversely affected consumer spending. Clearly, the GDP data on the previous page show that consumers have not stopped spending. Consumer sentiment surveys also show that the household sector remains generally upbeat.

A very tight labor market obviously keeps consumers feeling secure about their jobs and future income. The June unemployment rate was 4.5%, unchanged from May, and 132,000 additional workers found jobs last month.

Stable (not falling) home prices mean that significant home equity that owners have accumulated over the past several years is intact. The wealth effect from increased residential value has a long-lasting effect. People continue to cash out their home equity through refinances and home equity borrowing.

Equity investment has lately replaced the housing sector as a source of the wealth effect, thereby positively impacting consumption. The wealth effect from the stock market, however, tends to be concentrated in the more affluent segment of the population.

The housing slowdown alone will not be enough.

Recent employment and industrial production data show that the economy still has good momentum. Consumer spending remains robust and business investment has increased.

Because the ongoing housing correction has turned out to be gradual, it would likely take a bigger shock (perhaps combined with decreased residential investment and construction employment) to send the economy into a recession.

What could that additional factor be? Skyrocketing energy prices? Inflation and rate hikes? Some economists point to possible stock or currency market corrections. Others mention large debt loads of U.S. businesses and consumers. Leave it to economists, if you wish, to come up with more recession scenarios than you might care to ponder.

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Economic Forecasts – July 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	3.2	3.3	2.1	3.1
Unemployment (%)	5.1	4.6	4.6	4.8
Payroll Employment Growth (%)	1.7	1.9	1.3	1.0
CPI Change (%)	3.4	3.2	2.6	2.3
Federal Funds (%)	3.2	5.0	5.2	5.0
Housing Starts (millions)	2.07	1.81	1.50	1.56
Car/Lt. Truck Sales (millions)	16.9	16.5	16.4	16.7

Bold: Actual.

The information in this report is based on data available as of July 9, 2007, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.