"House Partiers" may be due for major hangover

AMERICA'S HOUSE PARTY

Record home prices are inflaming passions—and pocketbooks—as never before. Inside our raucous obsession with real estate

By JAMES PONIEWOZIK

JOHN WILLIAMS, A DISC JOCKEY FROM LONG BEACH, Calif., is available for weddings and birthday parties. He also does real estate closings. Williams, 40, recently decided to hitch his fortunes to the Southern California home market, buying houses, fixing them up and—in the parlance of our times—flipping them for a quick profit. "I saw so many friends and colleagues getting rich," he says. "I wanted to get rich too."

Williams has made some money—he flipped his first two prop-

Illustration for TIME by Tyson Smith

E27

Foreign buying of treasuries helped keep interest rates lower than they ordinarily would be in economic recovery, allowing buyers to bid home prices up to ever higher levels.

Housing Gets Even Less Affordable

Continued From Page D1

gap has been widening," says Barbara Ryan, an associate director at the FDIC.

To be sure, housing prices could continue to climb, thanks in part to interest rates that are still at historically low levels. In addition, how much impact declining affordability will have depends in part on whether it's offset by shifting demographics and by rising employment—which creates rising incomes—says David Berson, chief economist of **Fannie Mae**. Another factor: what happens to demand from investors who tend to focus more on total return than on their monthly payments.

As affordability has declined, many borrowers have increased their buying power by shifting to adjustable-rate loans and interest-only mortgages, which allow borrowers to pay interest and no principal in the loan's early years. More recently, many have embraced option ARMs, which give borrowers multiple payment choices. Borrowers who elect to make the minimum payment can see their loan balance rise, which is known as "negative amortization."

"We postponed the inevitable with these interest-onlies and negative-amortization" loans, says David Lereah, chief economist of the National Association of Realtors. "But you can't sustain double-digit price appreciation and keep homes affordable."

So far, the steady upward appreciation in prices hasn't had much of an impact on home sales. The NAR yesterday boosted its forecast of existing-home sales to show a rise of 2.8% to 6.97 million this year, setting another record.

In California, where affordability is a big problem, more-affordable areas are

PRICES MAXED OUT

The Least-Affordable Housing Markets

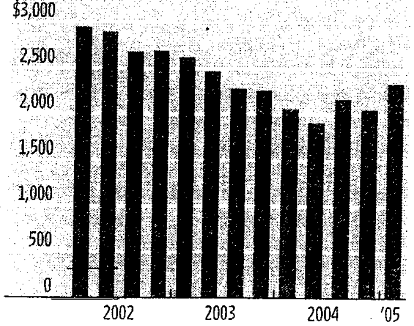
Here are some of the nation's least-affordable markets, based on how much of a median-priced house can be bought by someone earning the median income in that market.

METRO AREA	4Q 2004	1Q 2005
Merced, Calif.	29.0%	**27.6%**
Visalia, Calif.	37.1	**35.4**
Santa Cruz, Calif.	41.1	**38.7**
San Diego	50.9	**48.4**
Los Angeles	51.7	**49.4**
Salinas, Calif.	51.7	**50.1**
Santa Ana, Calif.	54.5	**52.5**
Santa Barbara, Calif.	56.5	**53.9**
Santa Rosa, Calif.	56.5	**54.3**
Redding, Calif.	55.8	**54.5**
San Francisco	57.4	**55.9**
Napa, Calif.	61.1	**58.9**
Honolulu	62.2	**60.1**
San Jose, Calif.	64.9	**62.6**
Chico, Calif.	65.7	**62.9**
New York	65.8	**64.3**
Oakland, Calif.	68.3	**66.0**
Miami	69.8	**66.2**
Riverside, Calif.	75.2	**70.5**
West Palm Beach, Fla.	78.4	**73.1**

Notes: This affordability index measures the percentage of the median-priced existing home that can be purchased by a

Mortgage Payments Hit the Wall

Mortgages aimed at boosting affordability are starting to lose their punch. Below is the average initial payment on new mortgages taken out to buy homes.*



*Data for jumbo mortgages, currently loans above $359,650

Source: Bear Stearns Cos.

seeing bigger price gains. Home-price growth in San Diego and Orange County, two of California's least affordable markets, has dropped to the single digits, according to the California Association of Realtors, while prices have climbed more than 20% in less expensive areas, such as Riverside-San Bernardino.

Overall, just 16% of households in California can afford the median-priced home, according to the California Association of Realtors, the lowest level since 1989, when the average rate on a 30-year fixed-rate mortgage was 10.33%. Rates on 30-year fixed-rate loans currently average just 5.81%, according to HSH Associates in Pompton Plains, N.J.

Until recently, innovative mortgage products have made it easy for home buyers to buy ever more expensive homes while taking less out of their pockets. Monthly payments on jumbo loans have risen only once since 2002, according to the Bear Stearns study. That climb came when rates jumped in the third quarter of 2004 and was quickly reversed thanks largely to the surging popularity of option ARMs. Option ARMs and interest-only loans have accounted for 65% to 70% of jumbo-mortgage originations in recent months, according to UBS AG.

The new data suggest "the housing market could cool under its own weight," says Mark Zandi, chief economist of Economy.com.

The advantages of shifting from a fixed-rate mortgage to an ARM or other affordability products have been declining as the Federal Reserve has boosted short-term interest rates and the yield curve has flattened, narrowing the gap between short- and long-term interest rates. Rates on ARMs that are fixed for the first year currently average 4.7%, according to HSH Associates. That's the highest level since July 2002, and just 1.11 percentage points lower than the rate on a 30-year fixed-rate mortgage. As recently as May 2004, borrowers could cut the rate on their loan by 2.41 percentage points by opting for a one-year ARM instead of a 30-year fixed-rate mortgage.

The initial teaser period for some mortgage rates can be as brief as a month.

Higher short-term rates are also reducing the attractiveness of option ARMs. Once the initial teaser period—which can be as brief as a month—ends, rates on these loans can jump to 5.5% or more, not much lower than the rate on a traditional 30-year fixed-rate mortgage. Credit-rating services recently set tougher standards for option ARMs because of fears that borrowers who hold these loans will default at a higher rate. That, says Dale Westhoff, a senior managing director at Bear Stearns, "ultimately makes it more expensive to originate these kinds of loans."

A handful of lenders have tried coupling option ARMs with 40-year mortgages, but coming up with additional ways to reduce monthly payments is likely to be difficult. Standard & Poor's Corp. says some proposed mortgage programs it's been asked to evaluate recently are aimed at fixing the low payment for a longer period. Others try to manage the sharp increase in payments a borrower can face when the interest-only period ends or the option ARM resets, so that the mortgage balance is paid off during the remaining term. With some lenders offering rock-bottom teaser rates, "I don't know how much lower you can get" when it comes to reducing the initial monthly payment, says Standard & Poor's associate director Brian Grow.

E 35

Journal Link: *Determine how much house you can afford with the Mortgage Tools, at* **RealEstateJournal.com**

As home prices rose, riskier mortgage volume exploded

The Trillion-Dollar Bet

Homeowners Take Risks in a Bid for Lower Mortgage Payments

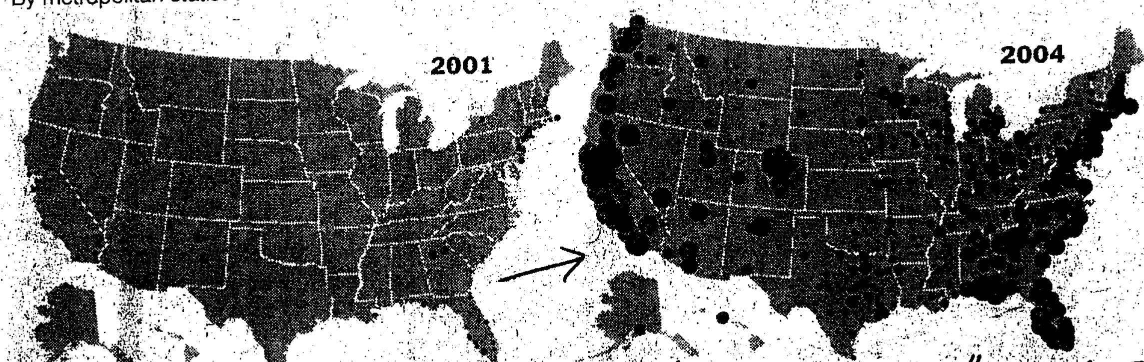
6-16-05

Risking Affordability

As home prices continue to rise across the country, home buyers are turning to riskier adjustable-rate mortgages to help buy homes that they would not otherwise be able to afford.

Circles on the maps are sized by the percentage of home loans greater than $360,000 that are interest-only loans. Does not include refinancing. By metropolitan statistical area.

PERCENTAGE OF LOANS 10% 40% 70%



EXPLOSION IN RISKIER "INTEREST ONLY" LOANS

	BASICS	PROS	CONS
Fixed Rate	Usually 15- or 30-year terms. Borrower makes fixed monthly payments on principal and interest.	Payment amounts are guaranteed and inflation effectively reduces them over time; borrower builds up equity gradually.	Borrowers who plan to move fairly quickly will have paid more with a fixed-rate loan.
Hybrid adjustable-rate mortgage	The mortgage rate is fixed for a period of time, usually 3 to 10 years, and then is reset based on market rates.	Initial mortgage rate is lower than on fixed-rate mortgages.	If rates go up when rate resets, borrower could be hit with much higher monthly payments.
Interest-only adjustable-rate mortgage	Rates may be fixed or adjustable. Borrower pays only interest for a certain number of years, after which borrower pays principal plus interest. Borrower can pay off principal at any time without penalty.	Initial payments are much lower than they would be if borrower were also paying principal. Good for people who expect big increases in income.	The spike in payments could be onerous. If home prices fall, a borrower could build up no equity despite years of interest payments.
Pay option adjustable-rate mortgage	Typically an adjustable-rate mortgage where the rate adjusts monthly. Each month, borrower has the option of four different payments, one based on an artificially low rate like 1.25%, one interest-only on that month's rate, one principal plus interest on a 30-year schedule and one principal plus interest on a 15-year schedule.	Initial payments can be extremely low. Good for people with variable income who want flexibility.	If borrower makes only minimum payments, the size of the debt will actually grow. After five years, borrowers must pay principal plus interest on a 30-year schedule, which could mean sharply increased monthly payments.

Source: LoanPerformance

E29

The New York Tim

CHRIS LESTER
Assistant Managing Editor/Business

Fed Reserve Study finds:

This will make you see red

Here are a few fresh takes on debt, a topic sure to get this Scotsman's kilt in a bunch, particularly as interest rates trend higher.

We'll start on the home front.

Every few years, the **Federal Reserve Board** conducts a comprehensive survey on the financial state of American households. The Fed's "Survey of Consumer Finances" for 2004 recently came out, and it unleashed a blur of interesting numbers.

Here are just a few trends:

Household Income falls (infl. Adj.)

■ Average inflation-adjusted household income declined 2.3 percent during the 2001-2004 period. In the previous three-year period, average household income had jumped 17.3 percent.

Household Gains tied To housing

■ Despite the income slippage, average household net worth increased 6.3 percent during the 2001-2004 period. That gain was down from 28.7 percent during the previous three-year period.

■ Families made most of their net worth gains on real estate. The average value of primary residences increased 28.1 percent during the 2001-2004 period.

Few families are saving

■ Fewer families are saving money. The proportion of families that say they are saving money declined 3.1 percentage points in the recent 2001-2004 survey, to 56.1 percent.

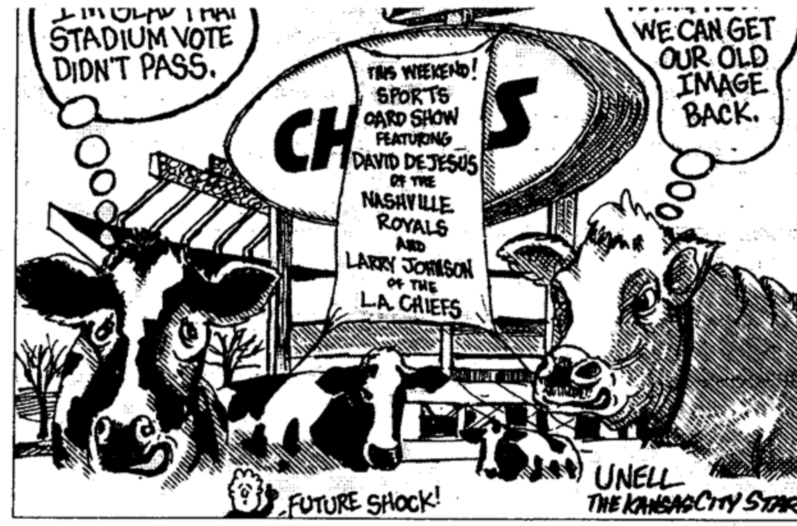
More families Deep in debt

■ More families are in debt, and deeper in debt. The proportion of families in debt climbed 1.3 percentage points, to 76.4 percent. The overall debt load of those families that are borrowing jumped 33.9 percent from 2001 to 2004.

Admittedly, that's a truncated summary of a 38-page report packed with numbers, charts and analysis. You can read the whole thing at **federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf.**

But, in general, it portrays many

See LESTER, D-11



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New bankruptcy rules

By MARK SHAIKEN
Guest Columnist

COMMENTARY

On Oct. 17, 2005, life under the new bankruptcy code began. One of the most important changes made by the new law is restrictions placed on the role bankruptcy judges will be permitted to play in Chapter 11 reorganizations.

Business bankruptcy cases are a delicate balance of rights and protections given to debtors, power and leverage given to creditors, and discretion given to bankruptcy judges to oversee the process. With such a balance, the parties in the case have been given the incentive to resolve their differences through business solutions.

Without appearing to give much thought to the effect on this delicate balance, Congress enacted a number of changes prohibiting bankruptcy judges from exercising discretion, such as the discretion to extend deadlines, and by doing so may have changed the balance dramatically.

Here are some examples:

■ **Plan filing deadlines:** In the past, judges had the power to extend the time within which Chapter 11 debtors could exclusively file a plan of reorganization.

The new law limits the judge's discretion to extend the exclusive plan filing deadlines to 18 months. As a result, Chapter 11 businesses will have to move through the bankruptcy process more quickly, and parties may be encouraged to "hold out" for the expiration of the deadlines, rather than attempt to resolve differences.

E6

The judge cannot determine in which cases the balance of debtor and creditor rights should be maintained to encourage resolution of differences. And in large, complicated business cases, 18 months may not be a sufficient period of time for the business to stabilize and a business plan to emerge.

■ **Real estate lease decisions:** Similarly, when a business commences a bankruptcy case, it previously had a short 60-day period to decide which real property leases to keep or terminate. Landlords typically wanted the debtor to make the

Housing glut reaches levels of the last real estate collapse: late 80's

NEW YORK POST
ONLINE EDITION

HOUSING MARKET GLUTS UP

By PAUL THARP

February 28, 2006 -- A sudden glut in unsold new homes is threatening to snuff out the blazing housing market that's been carrying the U.S. economy.

The Commerce Department said yesterday the backlog of unsold new homes in January reached the highest level ever of 528,000, with sales steadily sliding by as much as 5 percent.

Nearly half the new homes put up by builders aren't being sold as expected, the report shows.

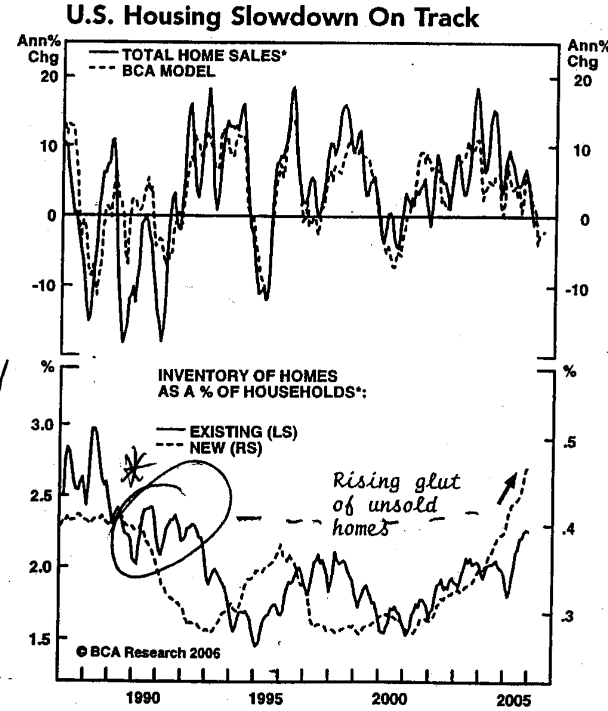
At the current sales pace, there were enough new homes on the market to satisfy demand for the next 5.2 months, the fattest inventory glut since November 1996.

Housing inventories at Same levels as late '80's

* THE LAST TIME WE REACHED THIS LEVEL OF PROPERTY GLUT!

① CREDIT CRUNCH OF 89-91
② RTC, BANK LIQUIDATIONS
③ MASS PROPERTY AUCTIONS.

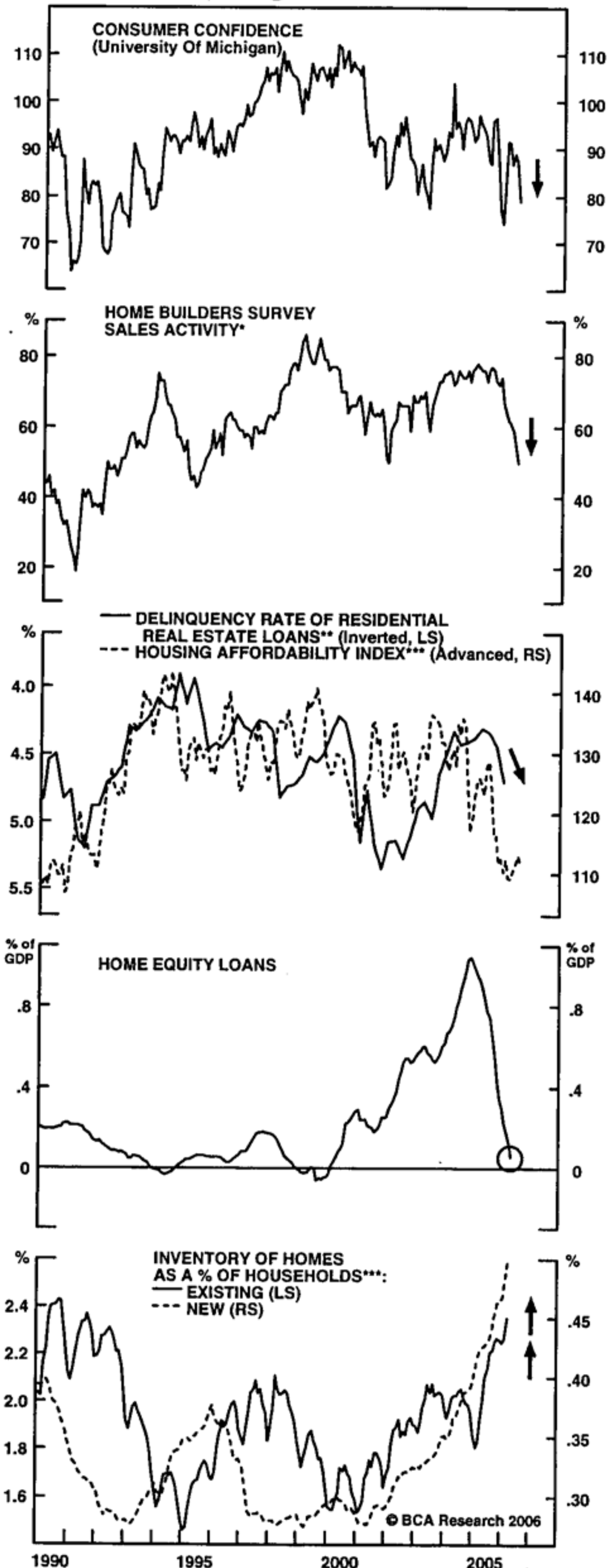
CHART 2
U.S. Housing Slowdown On Track



*SHOWN AS A 3-MONTH MOVING AVERAGE

consumption growth. The good news is that the business sector is in excellent shape, and unlikely

CHART 11
Consumers Losing Confidence



*SOURCE: NATIONAL ASSOCIATION OF HOME BUILDERS
**SOURCE: MORTGAGE BANKERS ASSOCIATION
***SOURCE: NATIONAL ASSOCIATION OF REALTORS

The combination of deteriorating housing activity and worries about energy (and the effect this is having on electricity rates) is eating into consumer sentiment. The preliminary University of Michigan poll of consumer confidence showed a sharp drop in May (top panel, **Chart 11**). Consumption growth has slowed in fits and starts since January, but not yet by enough to confirm that a period of trend or below-trend growth is underway. However, such an outcome looms in the coming months.

The boom in energy and commodity prices started the inflation scare back in late 2004. However, prices further down the supply chain failed to ignite. Finished goods producers have had great difficulty increasing selling prices because retailers face strong resistance from consumers. In fact, the PPI report last week showed that the core finished goods inflation rate has been drifting mildly lower. The same pattern is true for core CPI goods prices.

The sharp rise in gold prices in recent months has heightened inflation worries. Memories of the 1970s – when energy and gold prices soared in tandem as the dollar sank – have revived. However, the link between gold and inflation is tenuous at best. The "relationship" between gold prices and headline and/or core inflation that prevailed in the 1970s has long since broken down (**Chart 12**). In fact, the few times CPI has rebounded since the mid-1980s have not coincided with, or been led by, bull markets in gold prices (shown as the shaded areas in **Chart 12**). Soaring gold prices do not herald a revival in global inflation, but are part of the commodity stampede and reflect growing anti-dollar sentiment.

E12

incredible surplus of new construction!

NOTE, increase since March (2 months ago)

CALIF

California home sales drop 24% in January

Decline reflects rising mortgage interest rates and weakening consumer confidence.

February 28, 2006: 7:26 PM EST

SAN FRANCISCO (Reuters) - California's housing market is slowing as analysts had predicted, underscored by a slump in home sales in January, according to the California Association of Realtors.

MASSACHUSETTS

The Boston Globe

Mass. home sales plummet 21%

January prices also slip but condo deals climb

By Chris Reidy, Globe Staff | March 1, 2006

The number of single-family homes sold statewide fell 21 percent in January, the largest year-to-year decrease in monthly home sales since April 1995, and another sign that the once red-hot local real estate market is cooling, the Massachusetts Association of Realtors reported yesterday.

Based on the supply of homes for sale, up sharply from a year ago, the real estate market favored the buyer in January.

FLORIDA

Article published Mar 1, 2006

48% home sales drop leads state

One theory: Many well-off sellers await the 'right offer'

By Stephen Frater and Michael Pollick
STAFF WRITERS

E5

The high season peaked in mid-February but so far there is little evidence of a long-awaited and often-predicted real estate recovery.

In fact, the Sarasota-Bradenton market had the dubious distinction of being the Florida market with the biggest decline in sales during January: a precipitous 48 percent drop when compared with the same month a year ago -- more than double the state's 19 percent decline.

The Charlotte County-North Port market saw its sales drop 18 percent during the same time frame, the Florida Association of Realtors reported Tuesday.

CHICAGO

Tribune photo by José M. Osorio

Real estate agent Mike Sorensen says this bungalow has been for sale since November. The owner has lowered its price.

Sales slide for 5th month

Existing-home sales fall 5.2%; prices up

By Mary Umberger
Tribune staff reporter

A week ago Mike Sorensen got his client to lop $10,000 off the asking price for the Portage Park bungalow that has been for sale since November.

Then the phone started ringing, said the Northwest Side real estate agent, whose client came down to $359,000 after checking out other homes for sale in the neighborhood. Six showings are scheduled for Saturday, he said.

"Two or three years ago the property would have sold in two days," Sorensen said.

Realty has a different reality now, agents say, and data released Tuesday by the National Association of Realtors reflect it: Existing-home sales slowed nationally in January for the fifth consecutive month, down 5.2 percent from the year before.

The Chicago area fared only slightly better, with single-family sales down 4.8 percent from January 2005 and condo sales down 2.8 percent.

Prices continued to climb, nationally up 11.5 percent to a median of $211,000 for all types of housing. They jumped by 11.5 percent in the Chicago area, to a median $234,000 for single-family homes. Chicago condos went up 8.2 percent, to a $211,000 median.

The national existing-home numbers paralleled those for new construction released by the Commerce Department Monday, and analysts agreed that Tuesday's report is another sign of a softened market.

Nonetheless, they and local real estate agents said the traditionally busy spring market may revive sales, at least for the short-term.

"I expect we are in a bit of a trough that may be followed by a modest rise and then a general plateau in the level of sales activity," said NAR chief economist David Lereah.

Local agents are more terse: They said business is better.

"January was just kind of a hangover from Christmas. Nothing was moving," said Susan Devlin, an agent based in the South Loop.

"But right now, it's jumping, and there are pockets where things really fly, such as in Ukrainian Village or in the outer limits of the city, where people are looking for single-family homes."

Nonetheless, homes are taking longer to sell.

Inventory, the number of homes on the market, is climbing as the sales pace slows, the NAR reported.

Total inventory rose 2.4 percent at the end of January, to 2.91 million existing homes, which represents a 5.3-month supply.

In the Chicago area the Multiple Listing Service of Northern Illinois said it could not track year-over-year inventories, but reported that 22,560 homes and condos went up for sale in January, up from 18,337 new listings a year earlier.

Even with the higher inventories, prices generally will be slow to drop, analysts said.

"People will hold their house on the market longer, rather than accept a lower price," said Bob Walters, chief economist for Quicken Loans in Livonia, Mich. "A lot of sales are discretionary, and you'll see slowing sales before price declines."

Year-over-year data for January did show price declines in many Illinois counties, most of them far downstate.

However, double-digit price increases continued in the Chicago area, from 13.3 percent in Cook County (a $311,358 median price) to 32.1 percent in Lake County ($287,850), according to the Illinois Association of Realtors.

Deerfield real estate agent Honore Frumentino described the current market as "strange."

"On the very high end, we have two and three and four years of inventory on the North Shore," Frumentino said. "The break point is $3 million. It's really tough over $3 million. That's where the air gets really thin on the North Shore.

"I think it's the same in the western suburbs, where a lot of stuff in the $1 million to $3 million range is just sitting."

In the highest tiers, the North Shore is seeing price reductions, she said, citing a listing that has dropped to $4.2 million as of two weeks ago from $9.7 million last fall.

Washington economist Dean Baker said the January numbers shouldn't be given too much weight as an economic indicator.

"Monthly data tend to be very erratic, and I never make too much of a single month," said Baker, co-director of the Center for Economic and Policy Research, who has been outspoken in his prediction that house prices will decline, perhaps significantly.

mumberger@tribune.com

HOME PRICES ARE NOW FALLING

Home Starts Fell 7.8% in March Amid Rising Market Pessimism

By Christopher Conkey

The pace of new house construction slowed last month, and home builders are becoming increasingly pessimistic, signs of further weakening in the housing market.

Meanwhile, wholesale prices were up in March, but a tame reading on underlying prices suggests inflation is rising at only a moderate clip.

The Commerce Department said housing starts fell 7.8% in March to an annual rate of 1.96 million units, matching February's 7.8% drop to 2.13 million units. Although the pace of home building in March was 6.9% higher than a year ago, the recent declines indicate that the supply of new houses is starting to follow the downward trajectory of sales seen in recent months.

With sales declining, interest rates moving higher and the inventory of un-

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fell 1.4% in February. Much of the volatility is caused by gasoline prices, which jumped 9.1% last month, after an 11% drop in February.

The "core" producer price index, which is more closely monitored by economists because it excludes the volatile energy and food sectors, was up only a slight 0.1% from February and 1.7% from a year earlier. After more worrisome readings the two previous months, the tame figure for core prices in March assuaged fears that robust economic growth and rising oil prices will cause inflation to surge.

"The bottom line is that wholesale price inflation, outside the energy sector, is likely to remain in check, and the outlook for consumer prices remains good," said Peter Morici, a professor at the University of Maryland's Robert H. Smith School of Business. The Labor Department will release

← Homebuilding is slowing

... and prices are* falling...

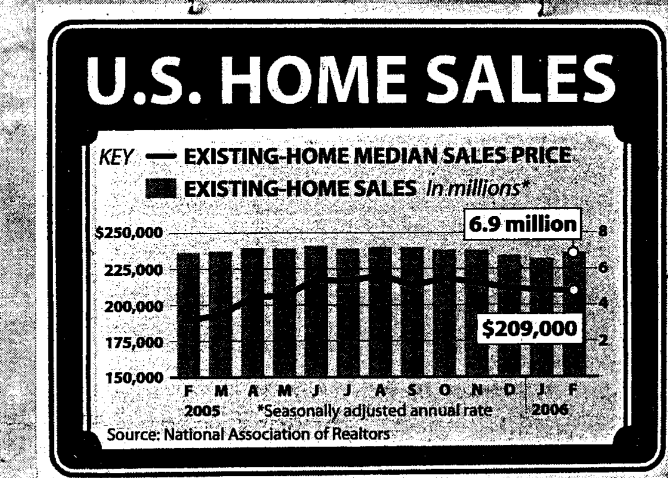
market managed a little, unexpected kick in February, when monthly sales of existing homes rose for the first time since September.

Aided mostly by warm weather, U.S. home sales defied expectations last month and rose 5.2 percent from January. Nonetheless, sales were a fraction of a percent slower than at the same time last year, which set a record, according to the National Association of Realtors.

The trade group also cautioned Thursday that the February sales probably do not signal that the market is about to take off again.

"Weather conditions across the country were unseasonably mild in January and were likely a factor in higher levels of buyer activity, which boosted sales that closed in February," said

3-24-06



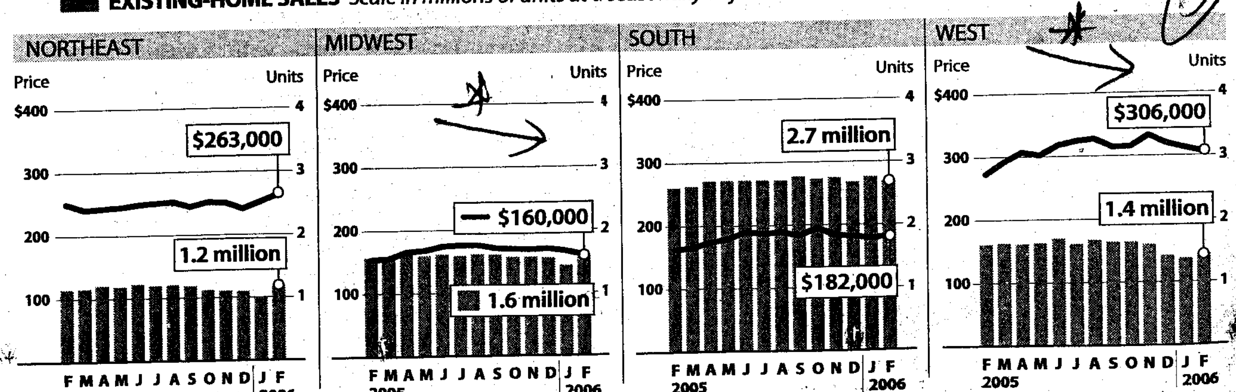
Tribune photo illustration

The nation's home sales surpassed consensus estimates in February, rising 5.2 percent from the prior month. Mild weather in January boosted February closings.

KEY — EXISTING-HOME MEDIAN SALES PRICE *Scale in thousands of dollars*

EXISTING-HOME SALES *Scale in millions of units at a seasonally adjusted annual rate*

5



Source: National Association of Realtors

Chicago Tribune

AP photo by Jae C. Hong

The frame of a home is nailed last week in Las Vegas. The Chicago Mercantile Exchange started trading a derivative that lets builders hedge losses and others bet on the direction of housing.

Merc launches futures contract based on indexes of home prices

Bloomberg News

Investors who say home prices have peaked might have a way now to hedge against a decline in residential real estate.

The Chicago Mercantile Exchange on Monday rolled out a new derivative: futures contracts based on indexes that track house prices. The contracts are designed to let pension-fund managers bet on housing, and builders hedge losses.

They might be a tough sell. The exchange delayed the debut twice to fine-tune indexes that potential buyers say fail to reflect a market where the underlying properties aren't uniform.

"It's very hard to come up with a kind of trading instrument that would truly reflect the risk and the reward when, in fact, the basic asset is not the same," said Sam Zell, chairman of Chicago-based Equity Office Properties Trust and Equity Residential.

The Merc traded 52 housing futures Monday. The most active was the Los Angeles contract for May 2007, which fell 3.9 percent, to 294 index points, said Sayee Srinivasan, associate director of research and product development for the exchange.

"It's a new market. People have to figure it out," Srinivasan says.

The Merc's real estate futures are based on indexes of home prices from research started two decades ago by Robert Shiller and Karl Case, professors at Yale University and Wellesley College, respectively.

The Chicago Board Options Exchange says it plans to release by June 30 a rival housing contract that will be based on price indexes provided by the Chicago-based National Association of Realtors.

The indexes for both exchanges reflect U.S. housing prices in markets that include New York, Los Angeles, Chicago and Las Vegas.

Housing futures based on nationwide indexes rather than on one area or type of property lack the precision needed to make accurate bets, said Zell.

Economists share Zell's concern that the indexes, and the related futures contracts, might not accurately reflect price changes, said Michael Carliner, an economist for the Washington-based National Association of Home Builders.

Now used by Standard & Poor's, the S&P/Case-Shiller index is a composite of the changes between the most recent purchase price of a home and that of its previous sale. The index could fail to show changes such as the effect of remodeling on a home's value, Carliner said.

The National Association of Realtors indexes, used by the CBOE to measure the median price of home sales, could be skewed by the types of homes sold, he said. The median price for a given market will decline when more homes with prices on the lower end sell than houses with the highest prices. This can occur even when the sales price of every home rises.

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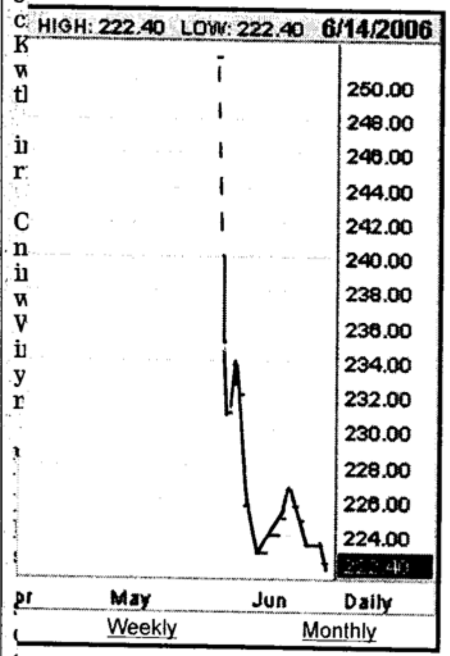

old kit!

HOME PRICE FUTURES ARE FALLING PRECIPITOUSLY
255→222 (33 pts)
OR
240→222 (18 pts)

E13

ABOUT ECRI

In the Press

Clouds gather over US economy

06/12/2006

"US inflation will peak..."

Monday view: Storm clouds gather over a US economy heading for icebergs By Ambrose Evans-Pritchard (Filed: 12/06/2006)

Like a thunder clap too close for comfort, the US bond market last week issued its time-honoured warning of recession. This time for real. The yield on 10-year Treasuries slid below the short-term rates, an emphatic signal that investors are more worried about a US housing bust than surging inflation.

Fear is creeping into the markets that a hyperactive Federal Reserve run by a chatterbox novice, risks sinking the global economy by tightening too hard - supposedly to curb prices, in reality to combat his fatal reputation as an easy-money ideologue.

Yes, bonds issued the 'inverted yield curve' warning in February. But those were halcyon days when the world was still awash with liquidity. The central banks of Asia, Europe and America have since succumbed to a belated and fierce bout of orthodoxy, raising rates in unison for the first time since the early 1980s.

Bernard Connolly, global strategist for Banque AIG, says the Fed, now chaired by Ben Bernanke, has already gone too far by raising rates sixteen times from 1pc to 5pc since June 2004, too much for an overspent economy running on fumes.

"Unless the Fed begins cutting rates by this summer, which it won't, then the US economy could be in for a nasty recession. The stock market has not yet woken up to the full gravity of this," he said.

If past is prologue, we have three or four months to find shelter before the full lightning storm begins. Buy government bonds, horde cash and shun risk, advises Joachim Fels, credit strategist at Morgan Stanley.

"Only once global GDP growth slows significantly - my story for the second half of this year and the first half of 2007 - and a new monetary easing cycle begins, can risky assets start to rally again," he said. Mr Fels has pencilled in the next upturn for mid-2007.

Beware the dollar too, warns HSBC's currency guru David Bloom. "Inflationary concerns will dissipate as the economy cools and it will become clear the Fed has over-tightened. This will herald the next wave of dollar weakness."

For now, Mr Bernanke seems determined to steam ahead with a quarter point rise to 5.25pc this month - and damn the icebergs. His pilloried "pause" talk in spring gave way last week to studied words about the "unwelcome" level of core inflation, now 2.1pc. Within hours the effects of this volte-face hit Turkey, South Africa, India and Thailand, all compelled to raise interest rates to defend their currencies and slow an exodus of foreign investors.

"He reintroduced testosterone to the inflation-fighting resolve of the Fed," said Diane Swonk, an economist at the US firm Mesirow Financial. She told the Washington Post: "This is a pure male thing. 'You think I'm a wimp? Take me on,' he said to the markets."

Yet the Fed's own staff said in May that inflation will peak over coming months before slowing later in the year. Hourly earnings are remarkably tame, rising just 0.1pc in April, down from 0.6pc in March. The Economic Cycle Research Institute's ECRI index, which signals future inflation, dropped 0.2pc in May and is now well below its peak in October.

Fed doves are pleading for caution. "We want to be looking through the windshield, we don't want to be just looking at the rear view mirror," said Governor Randall Kroszner.

Yet Mr Bernanke has buckled to the will of the Fed's monetary Ayatollahs - Dallas and St Louis come to mind - although he knows the risks of interest rate overkill all too well.

It was he, Professor Bernanke, who wrote the seminal 1995 paper - Inside the Black Box:

The Credit Channel of Monetary Policy Transmission - describing how inflation lags the cycle, flashing amber long after the real danger has switched to recession.

And it was he - scholar of the Great Depression - who blamed the Fed for crushing the American banking system in the early 1930s by starving it of funds. "You're right, we did it," he said theatrically as a junior Fed governor at the 90th birthday party of Milton Friedman. "We're very sorry. We won't do it again."

Talk about hostages to fortune.

E8

Mr Bernanke is counting on a "soft-landing" for the housing boom, the central pillar of the US consumer economy.

It provided $600bn of spending last year from home equity withdrawals - ie, from ever-bigger mortgages entailing ever-more debt.

This rosy assumption is looking shakier by the day. The inventory of unsold new houses is now at the highest level in a decade, rising by 1m properties to 4m over the last year.

The Philadelphia index of US construction equities has crashed 23.3pc since early May, pointing to an immediate wave of lay-offs.

Some 32pc of the 4.22m jobs created by the US economy since the expansion began in 2001 have been in the housing sector, more than four times the usual ratio, according to a study by Merrill Lynch. HSBC warns that US property has already tipped into a downturn, with the likelihood of outright price declines in the overheated markets of the East and West coast.

Ian Morris, the bank's chief US economist, said the combined cost of mortgage payments and house insurance for new buyers in California takes up 70pc of pre-tax income.

"Affordability is now worse than in 1981 when mortgage rates were 16pc. This is pretty scary stuff," he said, predicting a property slump lasting four to five years.

The Federal Reserve's blunder was to hold interest rates at almost free-money levels of 1pc until the summer of 2004, yet blowing fresh asset bubbles at home and abroad, and stealing prosperity from the future by pushing spending to the reckless level of 107pc of GDP.

The time for tough love was then, not now, sixteen rate rises later - with delayed effects only just starting to exact their toll. If Ben Bernanke had guts, he would now be holding the ground he staked out to Congress in April, explaining patiently that inflation lags the cycle. Are the bond markets telling us he has failed his first test of nerves?

more ECRI press quotes

32% of jobs since 2001 in housing!
(4x the usual level!)

Inventories of unsold homes are highest in a decade.

ABOUT ECRI

In the Press

European growth outlook is improving...

Euro Zone Inflation Pressures Up

06/02/2006

LONDON, June 2 (Reuters) - Inflation pressure struck a 5-1/2 year high in Europe in April and is steadily becoming a fact of life in Japan after many years when deflation was the problem, the ECRI institute said on Friday.

Increasing inflation in Germany and France pushed underlying price pressures in the euro zone to 5-1/2 year highs, an index from the Economic Cycle Research Institute showed.

Print

Pulte Homes Slashes 2006 Forecast as Orders Fall 29% (Update1)

June 2 (Bloomberg) -- Pulte Homes Inc., the largest U.S. homebuilder, cut its 2006 earnings forecast after orders in April and May fell 29 percent from a year earlier.

The company expects to earn $4.70 to $5 a share for the year, down from its previous forecast of $6 to $6.25 a share. Earnings in the second quarter will be 85 cents to 95 cents a share, the Bloomfield Hills, Michigan-based company said today in a statement.

Demand for U.S. housing is flagging at the height of what is usually the busiest time of year for real estate sales. Home-loan applications fell last week to the lowest level in four years, the Mortgage Bankers Association said yesterday. The average rate for a 30-year fixed mortgage was 6.6 percent last week, a four-year high, according to mortgage buyer Freddie Mac.

``Current demand varies by market, but overall it continues to transition after an extended period of stronger sales,'' Richard J. Dugas Jr., president and chief executive officer of Pulte, said in the statement. Orders are falling because of an increase in homes on the market, more cancellations and rising interest rates, he said.

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Last Updated: June 2, 2006 06:09 EDT

Print

Is a 29% drop in orders a harbinger of radical drop in Housing Starts?? If so, what happens to the 32% of all new jobs since 2001?

E14

6-16-06

[illegible] affair with sprawling [illegible] is showing [illegible] of waning as the real-estate market softens and aging boomers seek smaller houses. **June Fletcher** on nervous sellers and the growing supply of 'faux chateaux.'

M[illegible] put [illegible] five-bedroom, 6,200-square-foot home in Leesburg, Va., on the market in April, but already they've cut the price to $[illegible] from $1.1 million. Now, they've decided to put it up for auction.

What's the hurry? Down the street in their leafy subdivision, two similar-sized houses are also on the market, and around the corner, five more have for-sale signs. The Finns, who paid $692,000 for the new house in 200[illegible], recently retired and, with their two children grown, they're eager to move to a place half the size. "We don't need this big a house anymore—if we ever did," says Mr. Finn, age 63.

The golden age of McMansions may be coming to an end. These oversized homes—characterized by sprawling layouts on small lots, and built in cookie-cutter style by big developers—fueled much of the housing boom. But thanks to rising energy and mortgage costs, shrinking families and a growing number of retirement-age baby boomers set on downsizing, there are signs of an (Continued on Page W8)

McMANSION SLOWDOWN

A- The most job-intensive housing sector… a lot of jobs could be lost

B- Boomers downsize… perfect storm of Baby Boom & Housing Bubble

Housing boom will not end in a crash, says Harvard

6-13-06

By Christopher Swann in Washington

Bricks and mortar: 'Houses will revert to being something to live in rather than money makers', according to the head of Harvard University's housing studies centre

Markets seldom disappoint both bulls and bears for long. But over the coming years the US housing market looks likely to do just that, according to a study by Harvard University.

After the slump of the early 1990s and the surge of the past five years, the housing market might prove an anti-climax to all concerned. The long period of stagnation forecast by the survey would disappoint home-owners who expect big price rises but also those who missed the boat and have been hoping for a crash.

"Although housing prices are stretched, it is hard to see the catalyst for a crisis in the market," says Nicolas Retsinas, director of the Joint Center for Housing Studies at Harvard. "The overvaluation looks pretty well balanced by longer term supports for house prices, so we may just see a few years with little action. Houses will revert to being something to live in rather than money makers."

The study begins with some sobering observations about the record run in the US housing market. Over the past five years house prices have outstripped income growth more than sixfold – the median home now costs more than four times median household income in 49 out of 145 metropolitan areas in the US, a record. In 14 metropolitan areas, the median house is now worth more than six times median income.

Last year saw the average house price shoot up 9.4 per cent – the biggest rise in the average house price since records started more than 40 years ago.

Financial strains on US home-owners have been mounting. The number of Americans devoting more than half of their incomes to housing climbed by 1.9m to 15.6m in the three years to 2004.

To bridge the gap between sluggish earnings growth and speedy house price growth, ever more Americans have been tempted by riskier flexible-rate mortgage products. More than a third of loans last year were at adjustable rates and may rebound on their holders if interest rates continue to climb.

Even more reckless buyers, about 10 per cent last year, opted for payment-option mortgages – which do not require full payment of the interest costs.

So why will non-home-owners be deprived of the crash they have been waiting for?

The strongest underlying support for the market comes from accelerating household formation. Demand is being driven not only by population growth but by household fragmentation, as couples divorce or children leave home.

Immigration has been a still stronger force – over the past decade 12.6m new households were formed in the US. Over the next 10 years the pace of household formation will accelerate to 14.6m, according to the Joint Center for Housing Studies.

"Even if America decided to close the borders now, we would still see the lagged effects of previous waves of immigration," said Mr Retsinas. "Many of those that came to America earlier are only now in a position to buy property. As it is, we don't believe there will be any slowdown in immigration."

The Harvard study also argues that there are fewer points of vulnerability than during previous housing market downturns.

The macroeconomic outlook for the US is uncertain but no mainstream economists are predicting the kind of surge in unemployment or leap in interest rates that would prick the housing bubble. In spite of the shift towards flexible rate mortgages, 75 per cent of mortgage holders have 30-year fixed rate loans and are therefore largely invulnerable to rising rates. A third of households own their homes outright.

Nor are many likely to suffer from negative equity should rising interest rates or unemployment drive up defaults – about 94 per cent of home-owners have equity of more than 10 per cent.

Over-development has also been less of a problem than in the past, the study says. Price declines associated with episodes of big job losses alone average 4.5 per cent, while those occurring around periods of over-building alone average 8.3 per cent, it says.

Not everyone concurs, however. Many economists say national figures are deceptive, since they obscure pockets of extreme over-valuation in property prices and greater vulnerability to rising rates ...

evidence of overbuilding ... recent years. Resident... investment has risen to 6... cent of gross domestic pr... uct – its highest level in... years and much higher th... the average of 4.75 per ce...

The Harvard study c... cedes that even a slow... housing market could tak... heavy toll on growth, ... Americans become less a... to use their houses as A... machines and less empl... ment is created by hor... building.

Provided the slowdown... gradual, as Harvard expe... this could help rebalance ... US economy, reduc... demand for imports and ... stemming the growth of ...

E16

Long-term positive view: 14 million new households in 10 years