The Plow Horse Continues Its Course

The economy continues to plod forward thanks to a robust housing market. But how long will it last?

BY CHARLIE HALL

The latest GDP report reinforces my previous characterization that the economy remains a plow horse. Real GDP grew at a 1.2 percent annual rate in the second quarter, below the consensus expected 2.5 percent. However, some analysts are exaggerating the negatives in the report.

They say, for example, real GDP is up only 1.2 percent in the past year. But we have to remember that this follows a year in which real GDP grew by 3 percent. Average it out and we get 2.1 percent growth, the exact same plow horse average growth rate since the economy started to recover in mid-2009. Moreover, most of the unusual drag on growth in the past year has been from inventories and a drop in oil drilling and transportation, which are temporary phenomena.

Sometimes I like to look at "core" real GDP, which excludes inventories, international trade and government purchases, none of which can generate long-term economic growth. Core real GDP grew at a solid 2.7 percent annual pace in the second quarter. That includes a 6.1 percent annualized drop in home building that is likely to reverse in the quarters to come, given strong fundamentals in that sector.

In addition, the government revised up corporate profits by about 6 percent as of the first quarter of this year, supporting the views of bullish investors. Although some see the lower GDP estimate as a reason for the Fed to keep postponing rate hikes, it doesn't necessarily mean that it is. Nominal GDP (real GDP growth plus inflation) has grown 2.4 percent in the past year and at a 3.3 percent annual rate in the past two years, both high relative to a federal funds rate that still hovers at less than 0.5 percent.

A BRIGHT SPOT

Second quarter data contained one major bright spot — the strength of the U.S. consumer. The trade deficit also narrowed marginally but contributed little to overall growth. The rest of the economy contracted. Residential investment surprised many by reversing course and falling; business investment continued to contract; and state and local governments tightened their belts. Falling prices at the gas pump will provide a boost to consumer spending but could exacerbate losses in business investment. The oil industry needs oil prices to remain above the $40 per barrel threshold to break even.

The Federal Reserve's preferred inflation measure (personal consumption expenditures or the PCE index) rose at a 1.9 percent pace in the second quarter. That rise did little, however, to move the needle on inflation on a year-over-year basis, which held at 0.9 percent in the second quarter. That is the same as it was in the first quarter and still too tepid for many within the Federal Reserve to raise rates.

A GOOD START TO THE YEAR

Back in January, I stated that I had great expectations for the housing market this year — and so far, 2016 has certainly delivered. Looking back at the first half of the year, it's been nothing but good news. Total home sales are up 5 percent compared with the first half of 2015. Median existing home prices are up 5 percent as of June, setting a new record. Overall, we had the best spring in a decade.

Plus, continued robust appreciation has restored a lot of home equity for many homeowners — and

higher home values encourage owners to invest in home improvements and even to consider selling and buying again (to move up, downsize, get into a better neighborhood, etc.). So the obvious question is: How long will it last? Well, sorry to be a bit of a downer, but you shouldn't expect that same pace to keep up throughout the second half of the year.

One of the main factors driving this year's real estate market has been substantial pent-up demand that is driven by demographic trends. We are seeing the leading edge of millennials entering into homeownership in large numbers, particularly in more affordable markets.

At the same time, more baby boomers are making retirement decisions, providing inventory and powering sales. Even Gen X–headed families are active in the market this spring and summer because of improving economic circumstances.

All ages have been tempted by near-record lows in mortgage rates prompted by global economic weakness and instability driving investors toward U.S. bonds. (As demand for bonds goes up, so does their price, and mortgage rates go down). But even with all that demand, the market can grow only so much, because of the limited inventory of homes for sale. At today's pace of sales, existing home inventories would be used up in 4.6 months.

Sales so far this year have been able to grow because inventory has moved more quickly. We've seen the lowest national median days on market for listings on realtor.com in May and June (65 for both) than we have seen at any point in the recovery. But we can't continue to squeeze out more sales by upping the pace. We are likely close to the limit of how fast inventory can turn over. Eventually, without substantial growth in existing and new-home inventories, sales growth will probably flatten and even decline — despite strong potential demand.

The Fed's policy decisions don't directly affect mortgage rates, but the mortgage market will likely see rates rise if the Fed highlights signs of improving economic growth and inflationary pressures. Likewise, any positive news out of Europe and Asia could also drive rates higher.

So as a result of a very strong spring and summer leaving us with low inventories, mortgage rates potentially moving back up and the presidential election creating more uncertainty, we may see a weaker housing market in September, October and November. However, given the performance so far this year, 2016 should end as the best year in a decade.

As long as rates do not increase substantially in a short period of time (such as 100 basis points over the next six months), the real estate market should remain strong. After all, the underlying reason for higher rates is a stronger economy; so the benefits of that will offset the impact of marginally higher rates.

A stronger economy, more jobs, lower unemployment, and higher wages will continue to power demand. Higher rates will also likely help loosen credit. Those positive conditions coupled with demographic tailwinds from millennials and boomers will keep the U.S. housing market healthy and strong for at least two more years. ■

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