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AMERICANS RELYING TOO HEAVILY ON HOUSING WEALTH, SAY TD ECONOMISTS

- Rapidly rising home prices coupled with easy credit have prompted American homeowners to tap into their housing wealth at record levels.
- The resulting wealth effect has been a powerful economic stimulus that has accounted for as much as half of the growth in real consumer spending in the U.S. over the past two-and-a-half years.
- Despite relatively low mortgage rates, affordability is already eroding in a number of regions and personal debt loads are at record levels. Rising interest rates will squeeze housing demand and refinancing activity, causing a negative wealth effect to take hold and slow the U.S. expansion by the second half of 2006.
- However, if consumer confidence is seriously undermined or if a protracted house price correction takes hold, U.S. economic growth could very well slow to a crawl.

TORONTO – With the U.S. housing boom now in its fifth year, a TD Economics topic paper entitled *U.S. Expansion on 'Borrowed' Time* looks at the impact housing wealth has had on U.S. consumer spending behaviour. The report is available at www.td.com/economics.

The TD study found that the wealth effect has been such a powerful stimulus that its eventual and inevitable reversal will be the catalyst of a dramatic slowdown in the economy. "Many market pundits are locked in a debate as to whether the U.S. housing market is in the midst of a bubble. We have found that even if house prices don't contract, but rather, expand at a pace that is more consistent with longer-term trends, a waning wealth effect still has the power to dramatically slow the U.S. expansion," said Beata Caranci, economist with TD Bank Financial Group.

Housing wealth is important to almost all age groups and income brackets in America, but real estate assets are also a heavy weight within household balance sheets, totaling US$19 trillion in the first quarter of 2005. As a result, a relatively small percentage change in its value can have a big impact on consumer spending. "Using rather conservative assumptions that approximate the return to historical growth trends on real estate prices, realized capital gains and cashed-out equity, we found that the entire boost to spending from wealth would not only be wiped out, but would actually detract from real consumption growth for four-to-six quarters," remarked Caranci. "And, in all of our assumptions a nominal house price correction was never assumed." Under this scenario, the annual growth rate in real consumer spending would be shaved by as much as 0.7 percentage points. But, the TD report goes on to note that this is a 'best case' scenario. In reality, boom times are usually followed by a period when growth rates underperform historical norms. In such an event, the annual growth rate in real expenditures could easily be shaved by a full percentage point or more.

This leads one to question whether an early-1980s or early-1990s style house-price correction will repeat itself. Akin to those past periods, the current housing cycle has the eerie similarity of a central bank in the midst of a rate hiking cycle and erosion in home affordability. However, one key distinction is the relatively low supply of homes, which mitigates the possibility of a supply glut. On the demand side, low interest rates, a stable inflation environment and low unemployment have provided more sound footings for housing demand this time around. And, even though interest rates are headed higher, the central bank remains ahead of the inflation curve, suggesting that the future level of interest rates should remain less restrictive than that experienced in past boom/bust housing cycles. "However, there is one variable present in the current cycle that was not as prevalent in prior boom cycles – the size of personal debt burdens and credit made easy through interest-only loans and home equity lines of credit," noted Caranci. "This introduces an entirely new element of risk that has yet to be tested."

As 2006 unfolds, higher interest rates will increasingly pinch consumer wallets and refinancing activity will surely moderate – a trend that is already underway. With that, the wealth effect on consumption growth will wane and even turn negative for the more interest-sensitive components like cashed-out equity. This makes it increasingly unlikely that the U.S. consumer will power the economy as it had in the past three years.

A slowdown in consumption south of the border will have international trade ramifications for Canada. Although TD Economics believes that exporters will have largely completed the lengthy adjustment to the past appreciation of the loonie by 2006, export growth will likely be stunted by weaker U.S. demand in the second half of next year.

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For more information, please contact:
Beata Caranci
Economist
416-982-8067

***U.S. Expansion on 'Borrowed' Time* is available in PDF format on TD Economics' Home Page at: www.td.com/economics.**