



Top of the Business Cycle

May 24, 2005

Typically there is no bell that rings when we reach the top of the business cycle. But I have to share with you the fact that my ears are ringing! Consider the following facts.

First, the growth in real GDP has slowed in each of the last three quarters from a pace of 4.3 percent to 3.1 percent. Now a 3.1 percent growth rate is good, but the fact is that about half of the growth during the first quarter was the result of an unwanted build-up in inventories. Economic growth will continue to slow down as businesses work off their inventories.

Second, although oil prices appear to have peaked at about \$50 per barrel, producing pump prices of about \$2.25 per gallon, these prices are more than 25 percent ahead of last year. High energy prices act as a tax on real incomes, reducing retail sales. We are already beginning to see these effects in the data.

Third, interest rates are rising. While mortgage rates have yet to increase significantly, they will over the next ninety days or so. Mortgage rates are priced off of the ten-year Treasury bond. The bond rate has been held down over the last thirty months by a variety of special factors. Most important of these are: (a) Foreign central banks have purchased vast quantities of bonds in order to peg their currencies against ours – especially China, India, and Korea. Collectively they have increased their holdings by 65 percent. This cannot continue. (b) U.S. firms have not borrowed much because, until recently, they had high profits and could fund expansion without borrowing. However, profit growth has slowed and business borrowing is rising, so it is likely that the ten-year rate, and with it mortgages, will be rising.

Which brings me to the fourth point, the growing speculative excess in the residential real estate markets. Because mortgage rates have been so slow, mortgage debt per household has skyrocketed over the last five years, almost doubling! Many investors believe that real estate prices can only go up, but as one expert cautioned, trees do not grow to the moon. The data I collect and

review on real estate closings indicates that the rate of closings and the pace of price increases are already beginning to slow. For instance, in Orange County 2,118 existing homes closed in March – a good total, but well below their prior peak of 2,499 in July 2004. The average price at closing in March was \$241,890 which is up more than 15 percent compared to last year, but the rate of gain has slowed sharply. So this is the time to be prudent with investing in additional real estate.

I hear bells ringing!

This is Hank Fishkind for 90.7 FM, WMFE News.