



## **The Latest Data and Central Florida's Economy**

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Last week's economic reports were generally a bit better than expected.

First, new home sales rose to a new high of 1,316,000 on an annualized basis, up 2/10ths of a percent from March. A combination of low fixed rate mortgages and strong speculative demands are fueling sales. Here in central Florida sales of new homes also surged. Although it will be six to twelve months before these soaring home sales are converted into completed homes and the contracts close, the surge in sales is running well ahead of reasonable projections of population growth or household formation. This means that next year, when today's speculator's become tomorrow's owners, they may find that buyers for their homes or renters to occupy them may be in short supply.

Bearing directly on that matter was the release of the Federal Reserve's minutes from their May 3rd meeting, when they nudged up the funds rate for the eighth time. First, the minutes reflect a continuing commitment to raising rates. (Remember that the Fed only controls the rate on federal funds; very short term interest rate, and mortgage rates have not yet increased, but more on that later.) Second, the Fed explicitly recognized that higher oil prices are beginning to impact core consumer goods prices. Third, the Fed believes that the weaker data of this spring will be a temporary soft spot with rebounding growth later this year. Finally, the Fed concluded that U.S. housing markets are not overheating, but that there are "signs of speculative excess in some areas."

Well, in the very near term the Fed appears to be right that the economy may be a bit stronger than expected. The data on GDP was revised upward from a growth rate originally reported as 3.1 percent for the first quarter, to 3.5 percent. The revisions were due to a reduction in estimated imports offset by some reduction in inventory. Both of these are good signs, but they do not change the fundamental facts about the current state of the economy: it is weaker than before, and growth is slowing. Furthermore, while the inventory build up during the first quarter was not quite as awful as first reported, it is still bad and inventory levels will be a drag on growth during this second quarter of the year.

The recent behavior of mortgage rates continues to be a bit baffling. As we have discussed before, mortgage rates are priced off of the ten-year U.S. Treasury bond. Since the Fed began tightening last year, the funds rate has increased by 200 basis points, or 2 full percentage points, while the ten-year bond rate has actually dropped by 44 basis points. This is very strange. As a result, mortgage rates have dropped even as the Fed has tightened monetary policy. This unusual set of circumstances is unlikely to continue for very much longer, and I expect the bond rate to rise above 5 percent by the end of this year.

There are a number of special factors that have driven the bond rate down instead of up. Primary among these is foreign purchases of bonds. The huge trade deficit with China, Japan, Korea, and India gives rise to huge gains in dollars in those countries. Their central banks have recycled those dollars into U.S. bonds, holding down the rate on the ten-year and keeping the dollar exchange rate high. This cannot continue much longer. Further, until recently U.S. firms have enjoyed very high growth rates in profits. Firms used the cash flow to finance their operations and had little need to borrow. The sharp slowdown in profit growth this year will bring corporations back into the debt markets. And, finally, inflation is rising.

These three factors will cause the bond rate to begin rising soon and with it mortgages. And when mortgage rates rise, the speculative excesses in housing markets across the U.S. – and especially here in Florida – will become painfully obvious.

This is Hank Fishkind for 90.7 FM, WMFE News.