

# THE BUTTONWOOD



Fourth Quarter 2006



On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street.

There they signed the *Buttonwood Agreement*, creating the first investment community, which later evolved into the New York Stock Exchange.

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## HOW DO HOUSING PRICES AFFECT THE ECONOMY?

By Gail Gardner, CFP, ChFC

It's not news that housing played a big role in providing a soft landing from the recession that began in 2001 and ended in 2003. Federal Reserve interest rate reductions furthered that effect by triggering home equity borrowing and driving up home values. Indeed the impact of housing on the economy can be substantial. Housing and housing-related industries made up 23.1% of GDP in 2003 and have ranged from 20-25% of GDP for the last 50 years. So how exactly does housing affect the overall economy, and what will be the impact of the recent decline in housing prices?

One way the housing market affects the economy is through what is known as the "wealth effect." The theory goes like this: where consumers are concerned, anything that increases their wealth, or their perception of their wealth, also increases their propensity to spend. Stocks and housing are two classes of assets that are commonly included in wealth effect studies, both providing an increase in consumer spending of roughly 5.5 cents for every dollar of increase in value. However, increases in housing values have a more immediate impact. The experts disagree as to why this is so, but in general the argument is that stock wealth is perceived by

consumers to be less reliable, or more variable, than housing wealth. Also, increases in stock wealth aren't as likely to increase cash flow, since stock investors are often invested for the long haul due in part to short run volatility. In addition, it isn't as advantageous taxwise to borrow against stock as it is your home. Increases in stock values, then, tend to increase spending simply because consumers feel wealthier.

Increases in housing values, on the other hand, along with reduced borrowing rates, can have a direct impact through refinancing, home equity borrowing and money from the sale of one home that is not reinvested in a repurchased home. Also, the impact of housing is greater because it is typically a highly leveraged asset. You don't have to pay cash for your home in order to enjoy the benefits of price appreciation. You can purchase a home with anywhere from 0%-100% of the purchase price and borrow the balance, but you still own 100% of the price appreciation. That means it's possible to quickly achieve gains of up to 100% or better of your initial outlay in a rising market. The housing market also affects the economy through its impact on construction, mortgage finance, the real estate business, and purchases of furniture and appliances.

## HOW DO HOUSING PRICES AFFECT THE ECONOMY? (CONT)

*By Gail Gardner, CFP, ChFC*

The most recent concern is that decreasing home values will have a negative wealth effect, or will decrease consumer spending. That, combined with the slowdown in related industries, can contribute to the risk of recession. Everyone pretty much agrees on the general impact housing has on the economy, but not everyone agrees on how much of an impact it will have in light of other variables.

Because housing is a unique investment and provides benefits other than increased wealth, housing markets tend to correct, not crash. You can sell your stock and put the proceeds into a cash investment, but if you sell your home, where are you going to live? Most homeowners sell to repurchase in the same market. So while they may be selling their homes for less, they are also buying for less. Yes, inventories are up and prices are down, but homes are still selling. It just takes longer. Every housing market is unique. Home values tend to increase and decrease more in hot markets, like San Francisco, New York, Boston, Los Angeles, Miami, Phoenix, and Las Vegas. That makes those cities more vulnerable to large declines in value. So some areas have experienced deeper price declines than others. The unique nature of the housing market complicates predictions about how much of an impact it has on the overall economy.

The picture is further complicated by other offsetting factors. The last housing boom has

already performed its magic. It got us through a recession at a time when corporate inventories were high and spending low. Now that the surpluses have worked their way through the economy, business is in a position to take up the slack through increased spending and hiring. Also, commercial construction appears to be taking up some of the slack left by the slowdown in residential home construction. Energy prices have improved enough to help offset the negative wealth effect caused by the housing decline, and stock market increases should also contribute, if not immediately. And if that's not enough, the ace in the hole is that with the federal funds rate now at 5.25% as a result of a pattern of rate hikes that began in June of 2004, the Federal Reserve has created some room to lower rates, if needed, to stimulate the economy, or raise them if inflation becomes problematic.

We believe that housing prices will land softly, expecting more of a slow drop or flattening in prices than a sharp decline going forward. Mortgage rates remain relatively low, and there are factors that indicate demand will remain strong, including the growth in the number of single households, immigration, and second home buying activity. If this housing decline had occurred, as in the past, at a time when the economy was weakening, it could very well be a driving factor toward recession; however, this time around, the economy is actually improving. Earnings will be key in the economic outlook for 2007, as will inflation and energy prices. Barring any major negative moves in these key factors, or some kind of international incident, we expect the impact of this housing correction on the rest of the economy to be minimal.

*Have you been in recently to review your portfolio? If not, please contact us to schedule a meeting.*