

UCLAAnderson  
**FORECAST**



May 18, 2007

The End of the Goldilocks Economy  
What Should Investors Do Now?

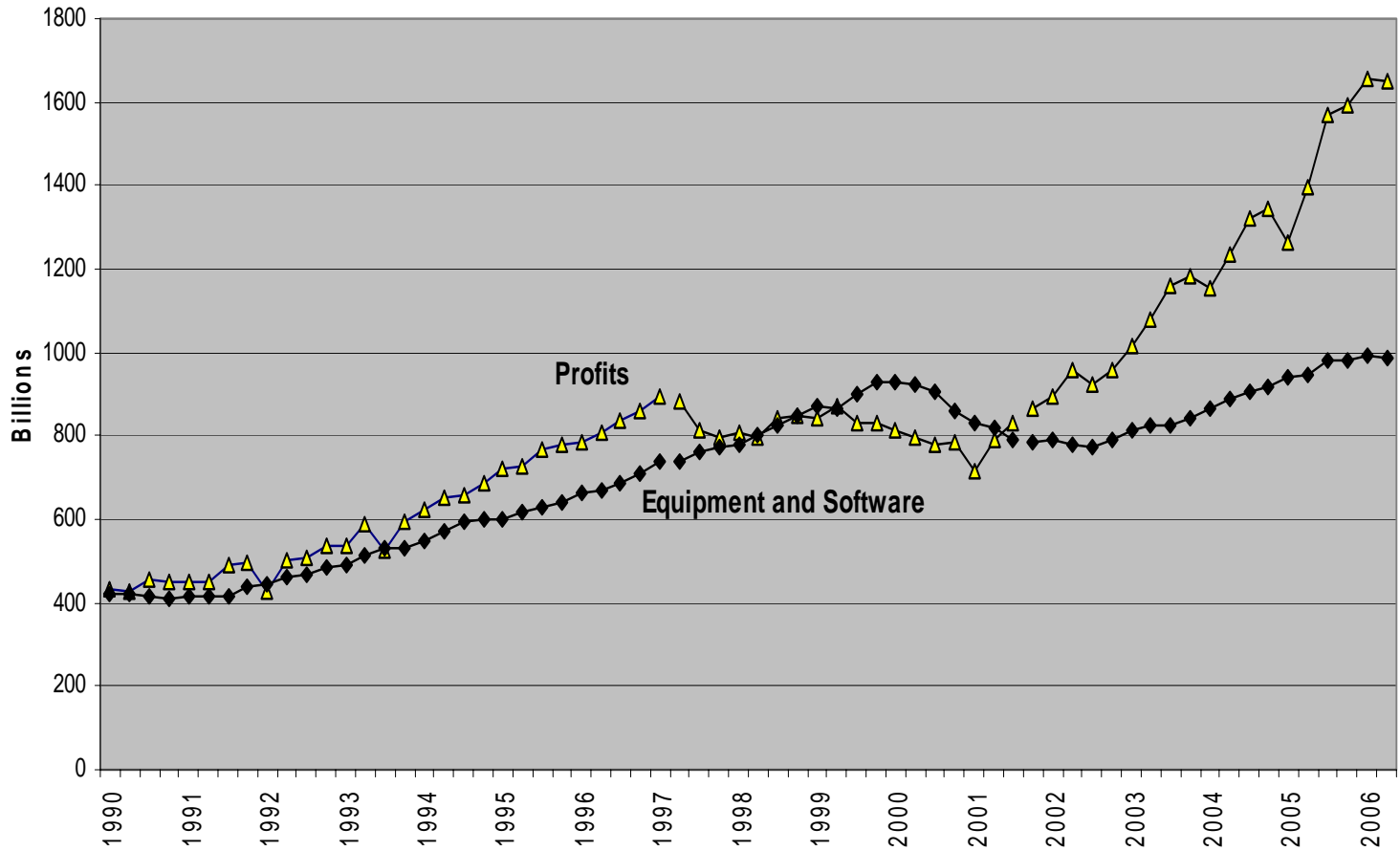
**EDWARD E. LEAMER**

**Professor of Management, Economics and Statistics**

Goldilocks Economy 2001-2006

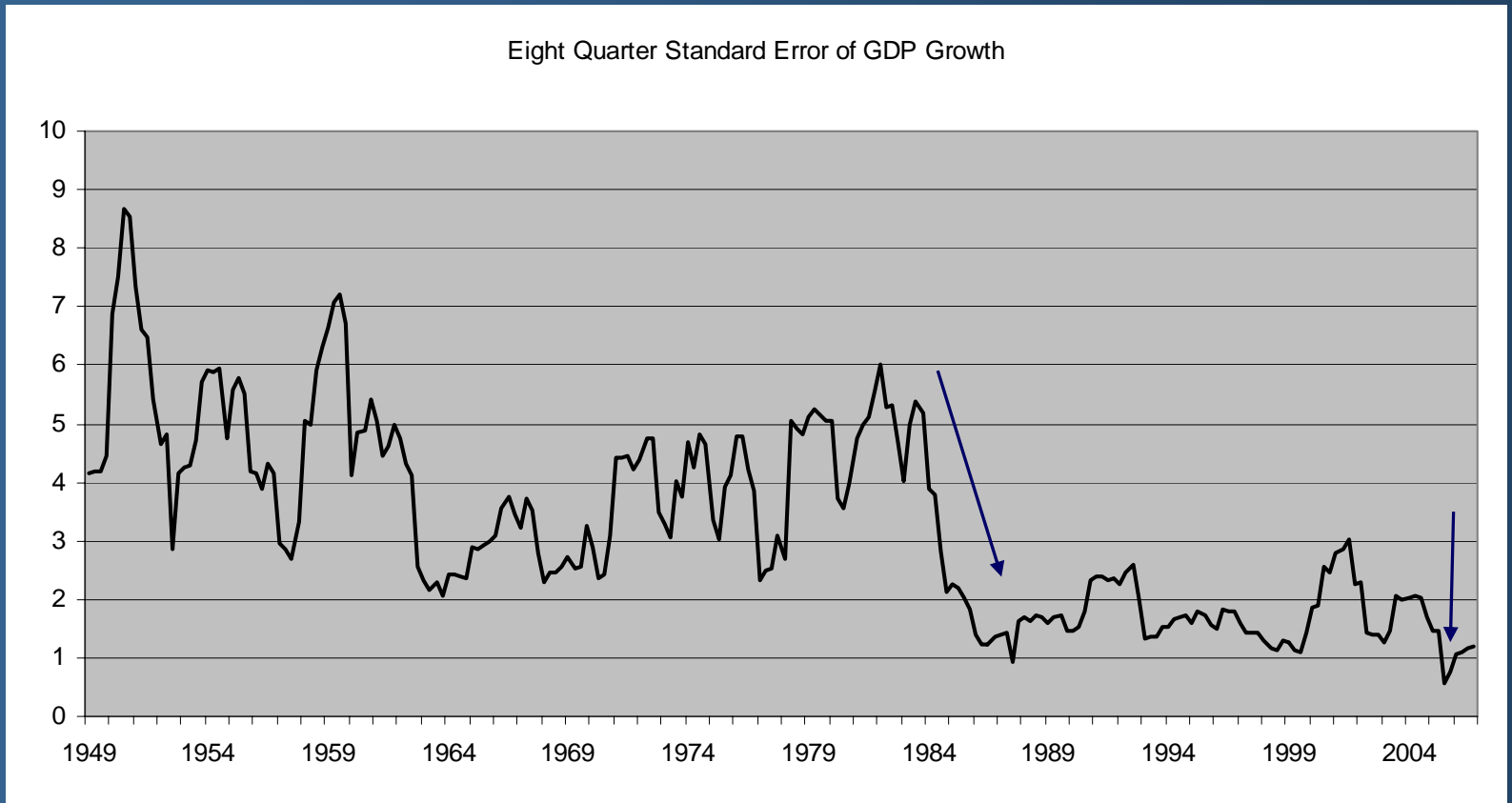
# Very Strong Profits

Corporate Profits and Investment in Equipment and Software



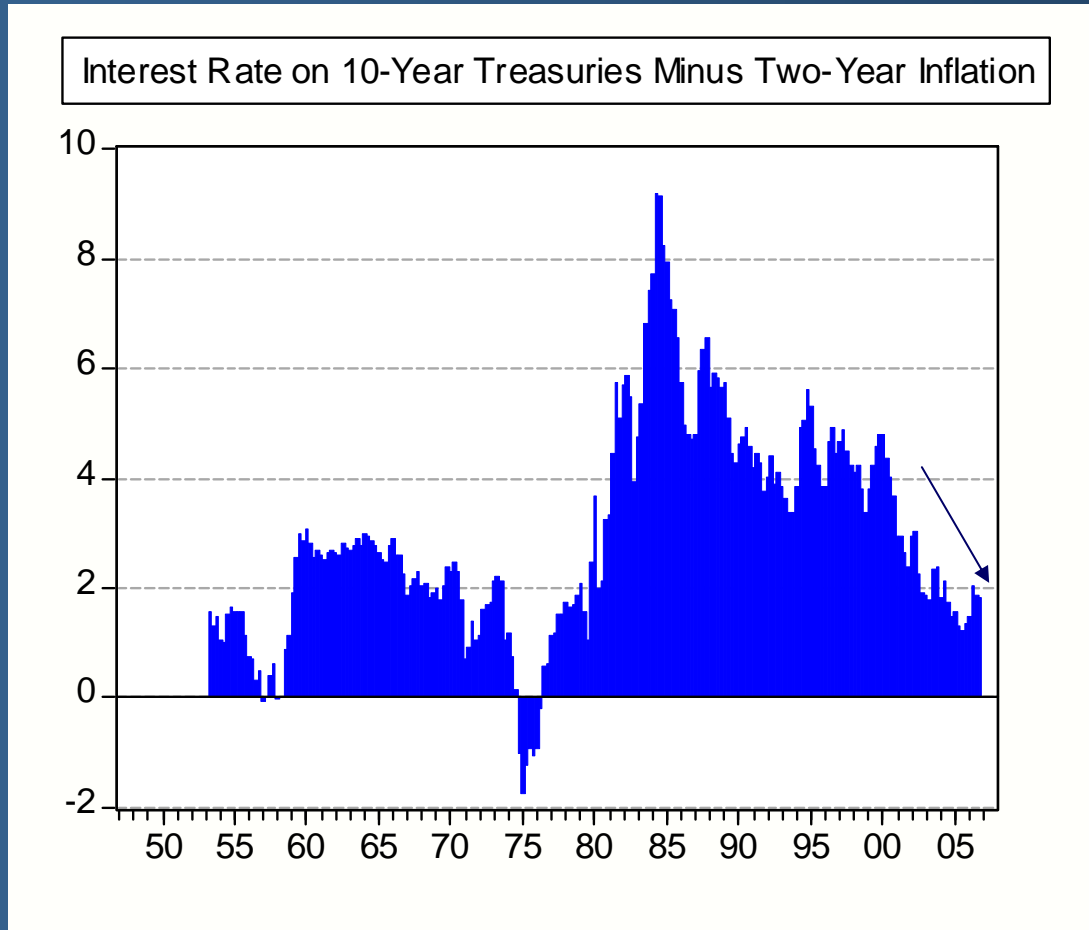
Goldilocks Economy 2001-2006

# *Very Stable Revenue Growth*



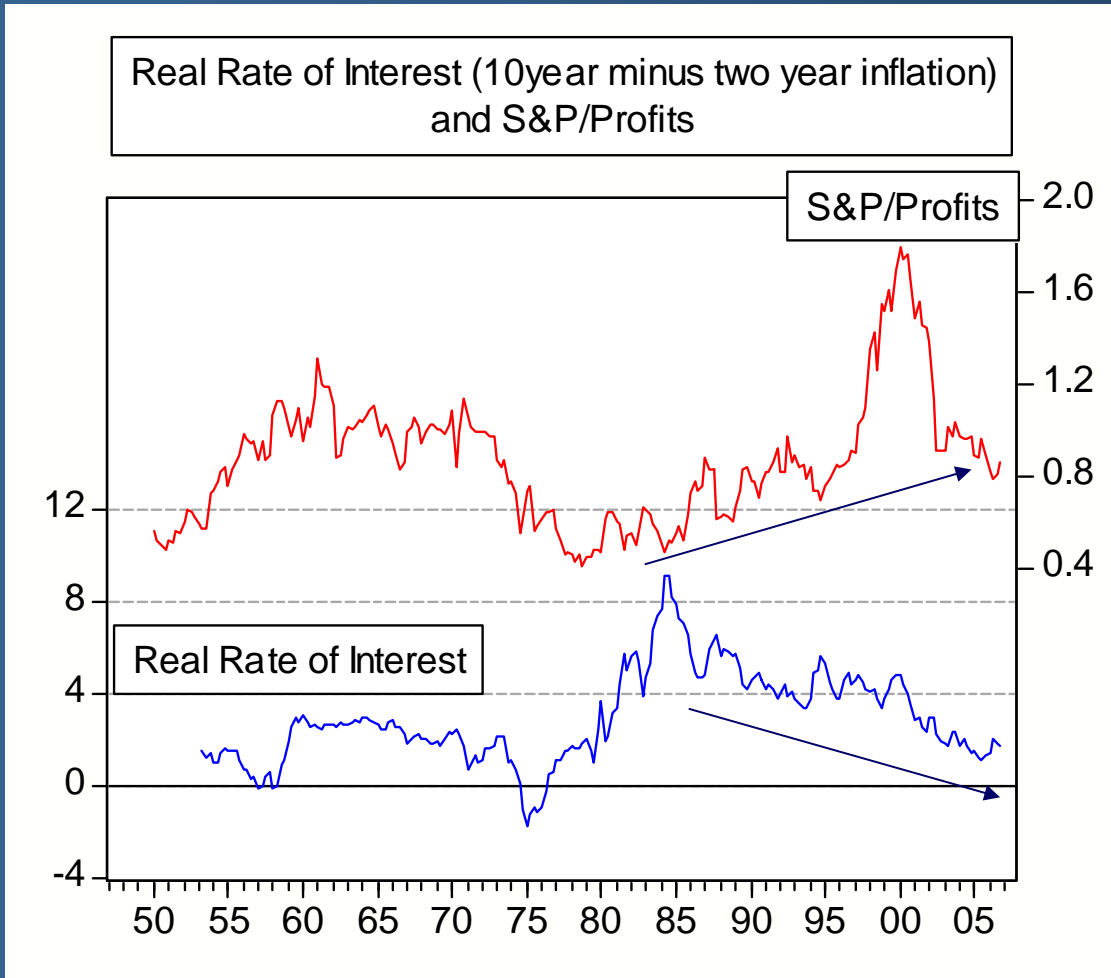
Goldilocks Economy 2001-2006

# *Low and Falling Real Interest Rates*



Goldilocks Economy 2001-2006

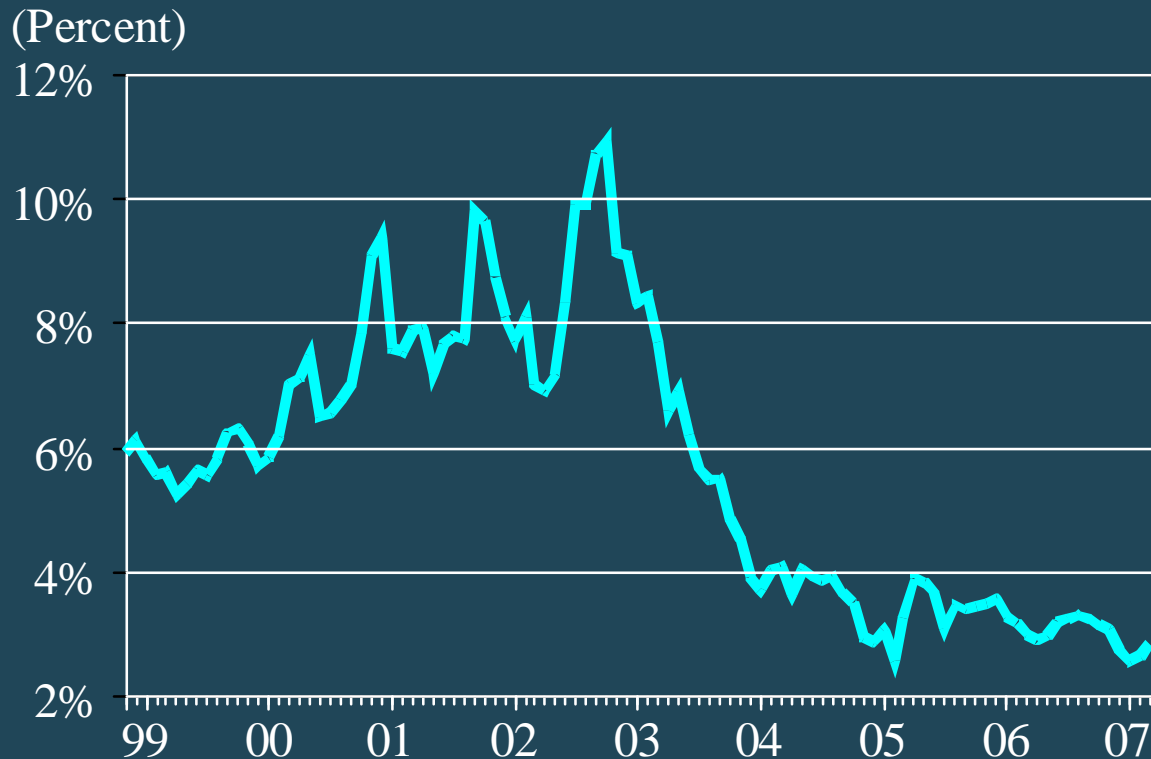
# *Thus high valuations*



Goldilocks Economy 2001-2006

# *Low Return for Risk. What's Risk?*

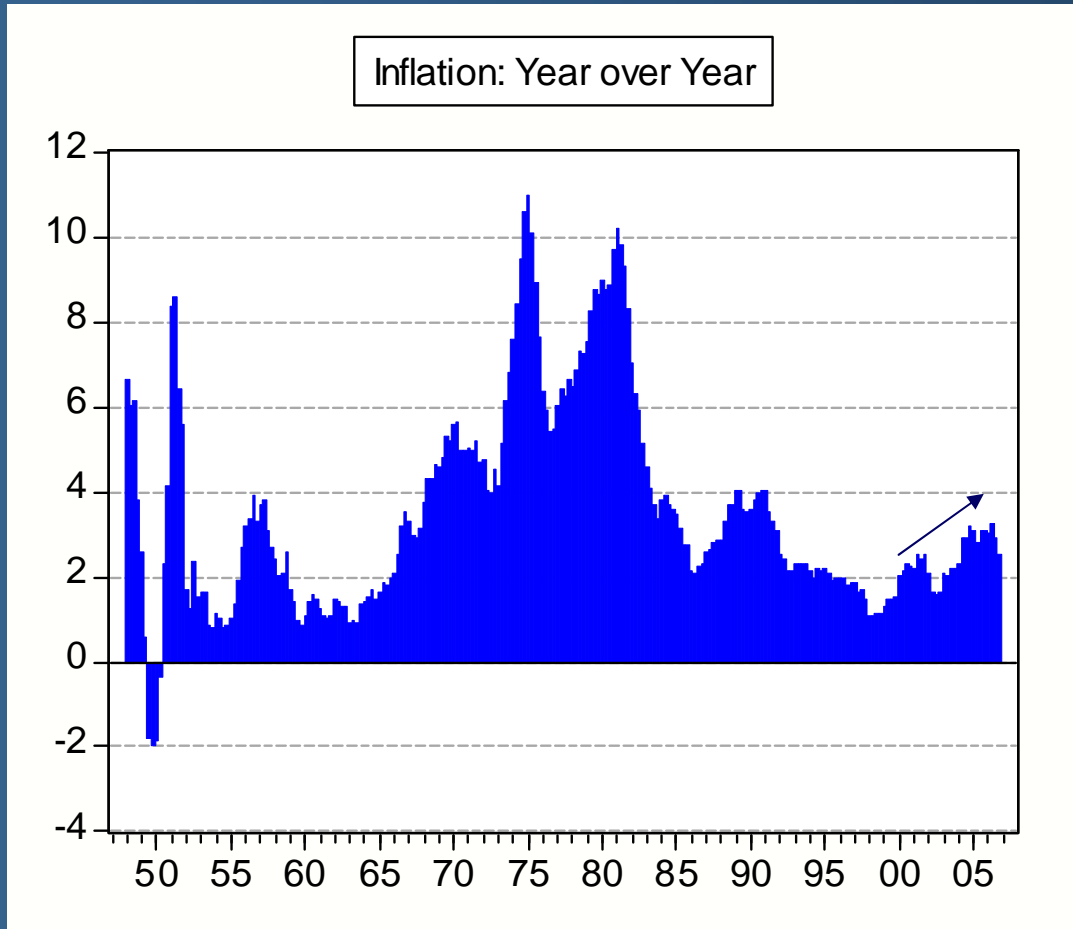
Figure 6. Lehman High-Yield Index, Option-Adj. Spread to Treasuries, Nov. 1998 - March 2007



Source: Lehman Brothers

Goldilocks Economy 2001-2006

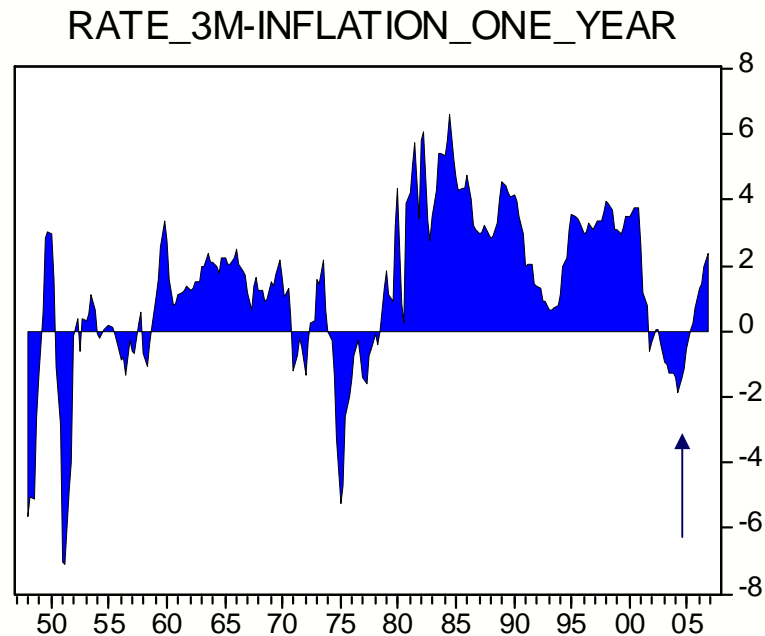
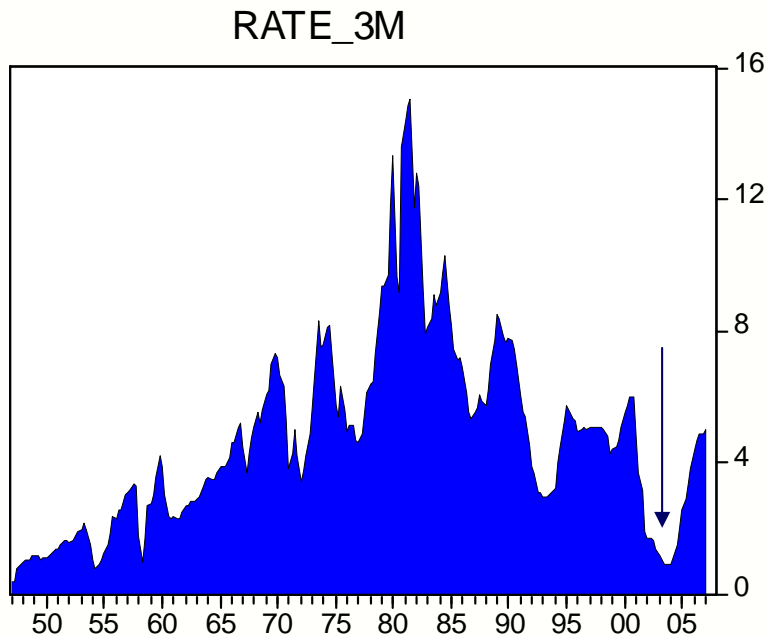
*But Inflation Got Too Hot, Not Just Right*



Goldilocks Economy 2001-2006

# *And the Fed took away the teaser rates*

The Interest Rate on 3 Month Treasury Bills

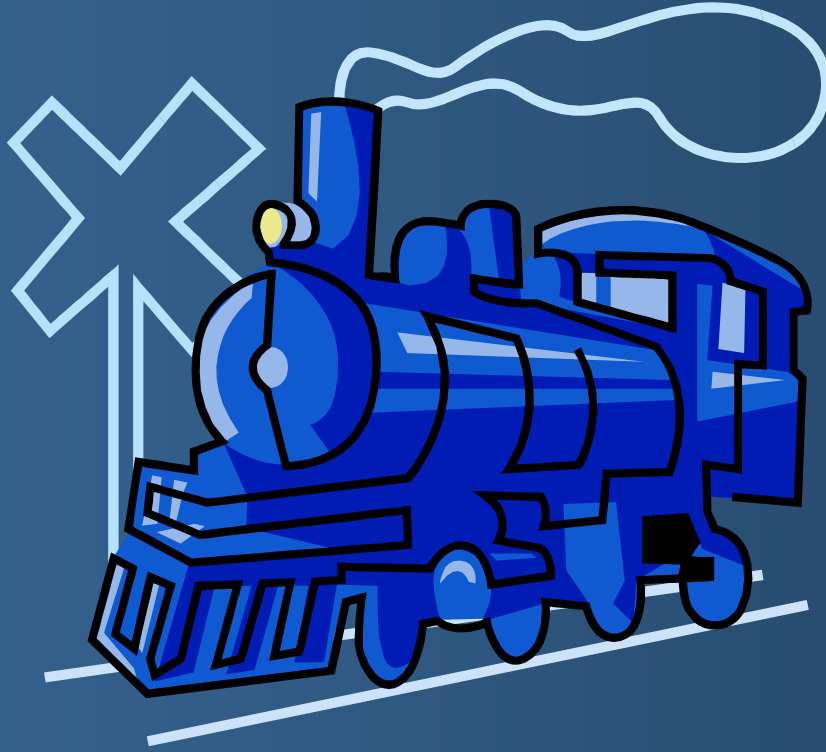


# And That Ended the House Party

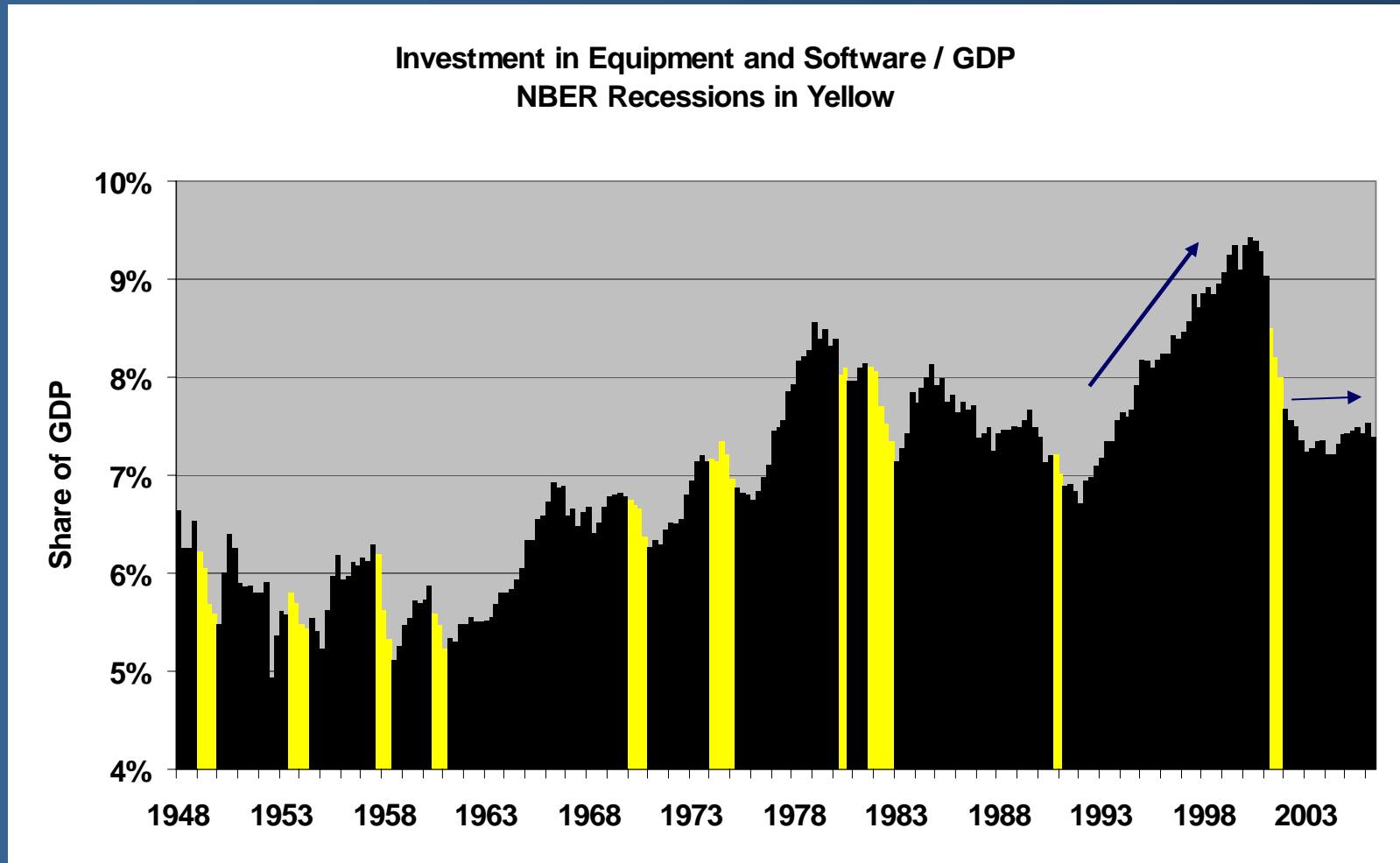
**How Deep,  
How Long  
How Contagious?**



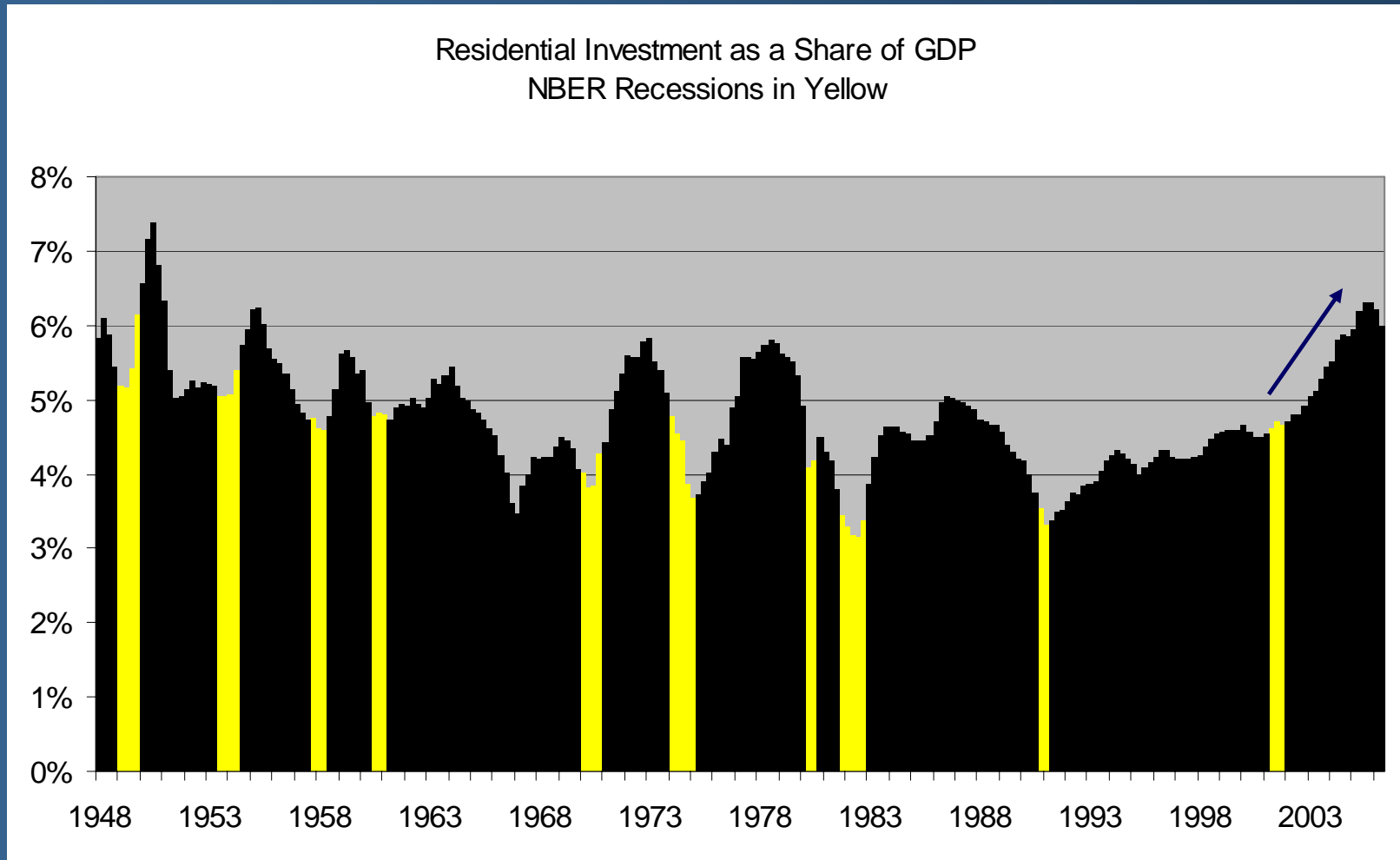
To keep it going, it takes a Locomotive



# Equipment and Software Investment Was the Locomotive From 1997 to 2000

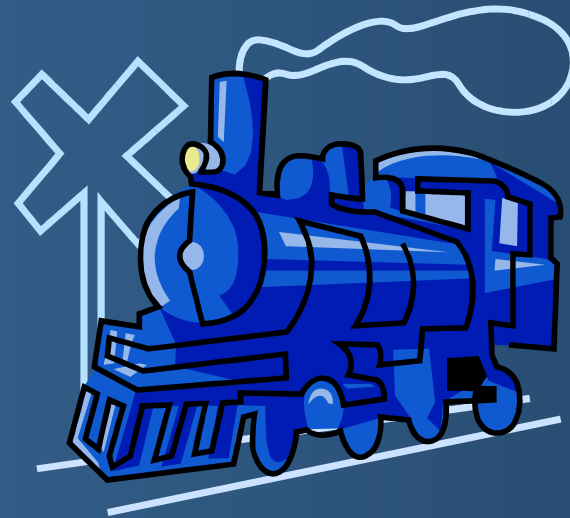


# Residential Investment Was the Locomotive From 2001 to 2005



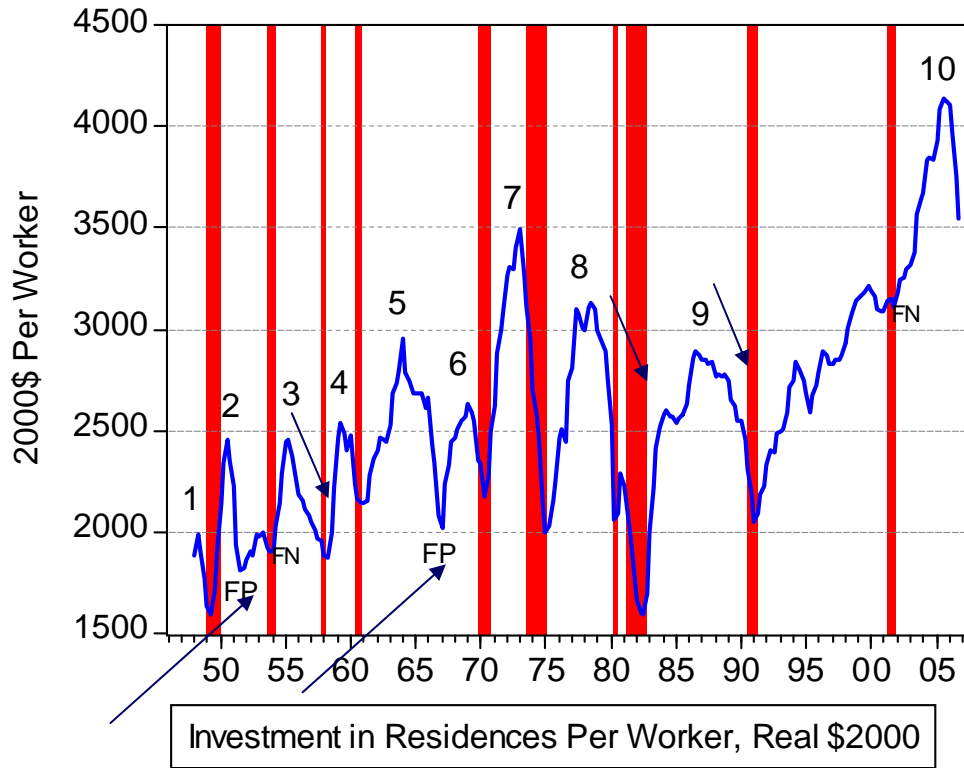
# What is the locomotive now?

- ◆ IT AINT BUSINESS INVESTMENT
- ◆ IT AIN'T HOUSING
- ◆ Without a locomotive, is it time for a recession????



# Collapse in Homes Predicts Recessions

Nine Mountains of Homes Correctly Predicted Seven Recessions  
 Two False Positives: 1951 and 1967  
 Two False Negatives: 1953 and 2001



# What's a Recession?



A *recession* is a “market failure” that causes a persistent and substantial increase in unwanted idleness

◆ Labor Idleness

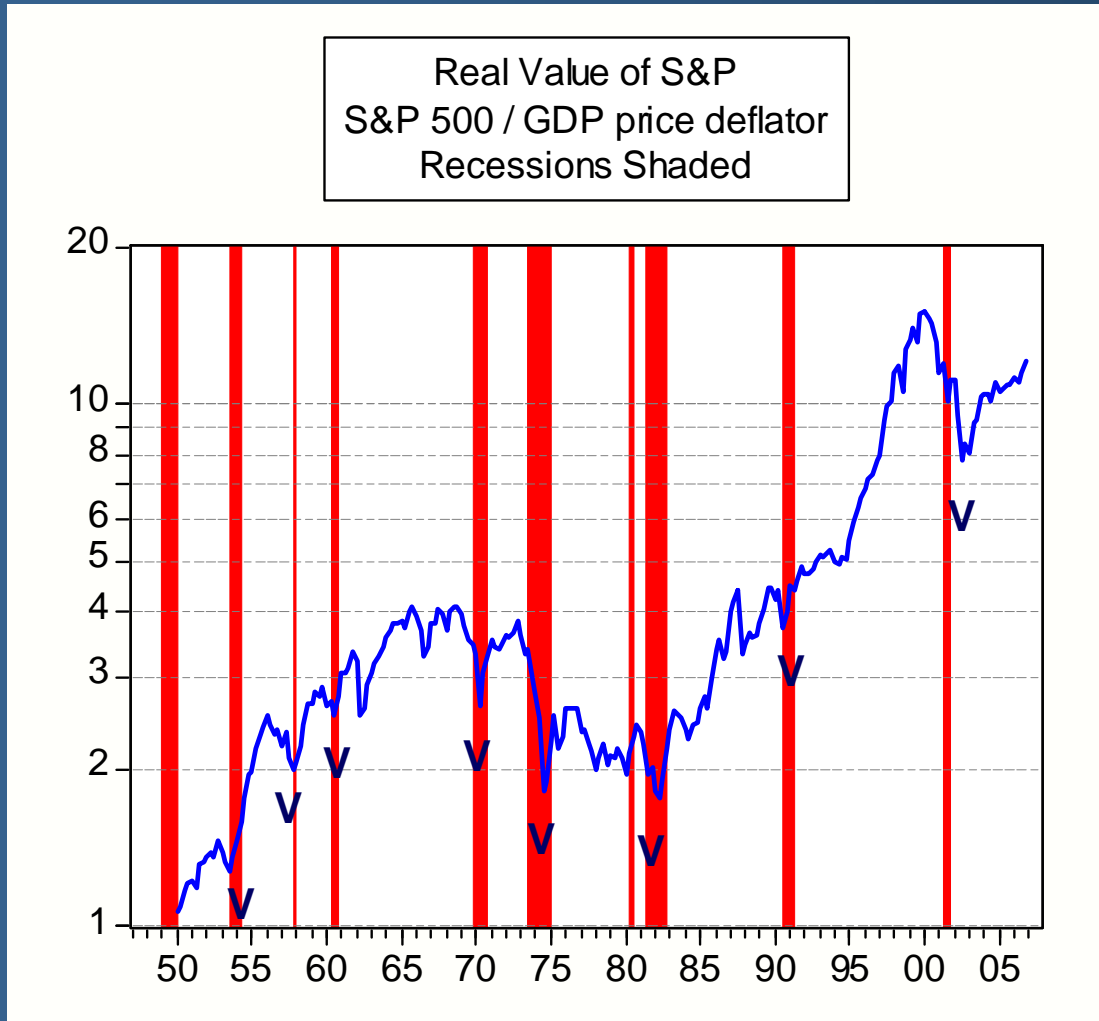
- Unemployment
- Low Weekly hours

◆ Capital Idleness

- Low Capacity Utilization in Manufacturing
- Vacancies in Offices and Apartments
- Inventories of vacant, unsold homes

# Why Worry about a Recession?

*It will hurt your portfolio*

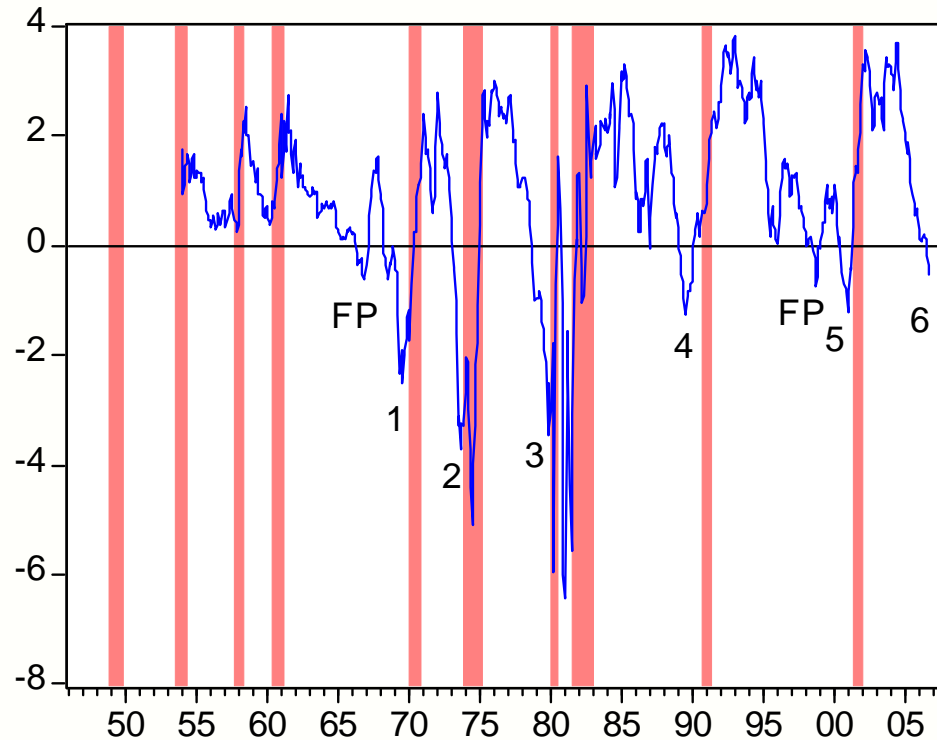


# The Interest Spread is Also Very Troubling

Both a predictor and a cause.

*But can there be a credit crunch this time??*

The Last Five Recessions Were Preceded by an Inverted Yield Curve  
There have been two False Positive during that period



— Interest rate spread, 10-year Treasury bonds less federal funds

# Characteristics of the Mortgage Market, 2001 vs. 2006

Characteristic*	2001	2006
% Subprime	6.3%	14.6%
% IO/Neg-am	2.0%	26.0%
% CLTV > 90%	4.8%	14.7%
% Limited Doc.	7.0%	20.0%
% Investor	3.6%	6.6%
Total Size (\$, billions)	4,500	8,050

*\*-Categories overlap*

*Source: Lehman Brothers*



# Hispanics in California Housing

## Top 5 California Homeowner Surnames

2000

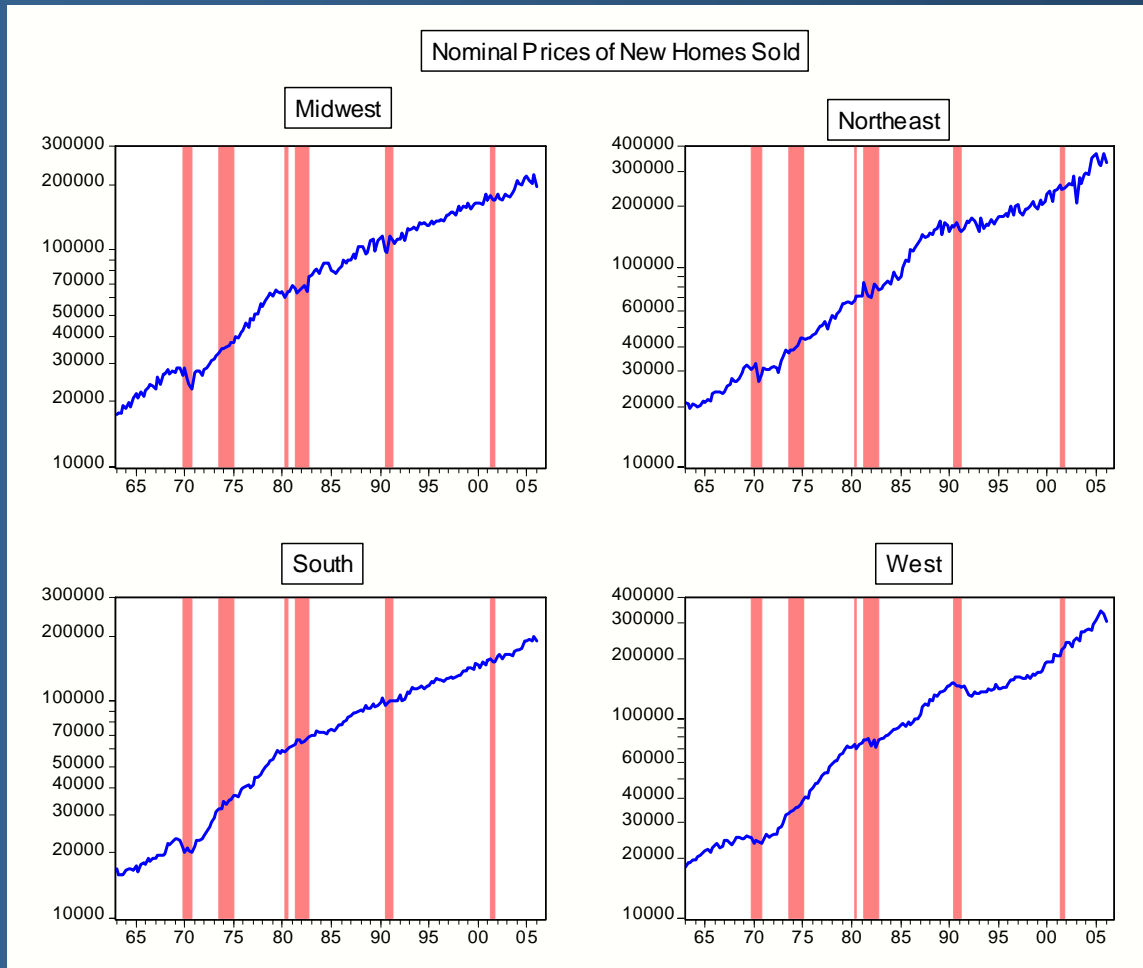
Garcia
Smith
Lee
Nguyen
Johnson

2006

Garcia
Hernandez
Rodriguez
Lopez
Martinez

Source: USA Today

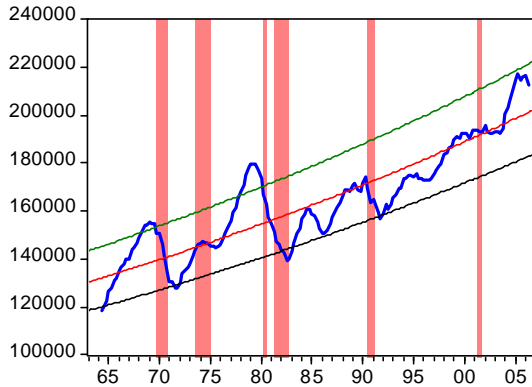
# Remember: Nominal Prices Don't Decline



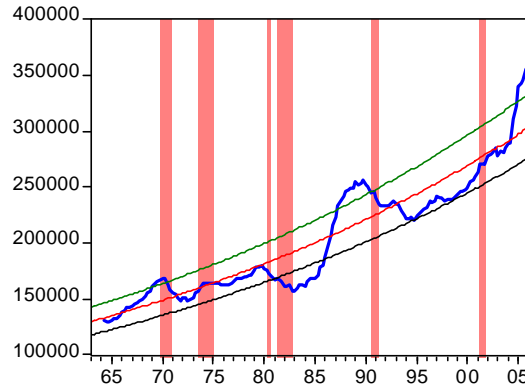
# Real Prices Do Decline

Median Real Price of Homes Sold (CPI, 2005=100)  
Trend Line, and Plus or Minus 10% Band

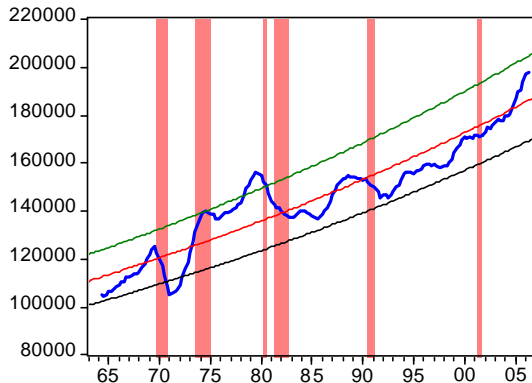
MIDWEST 1.0% Trend Line



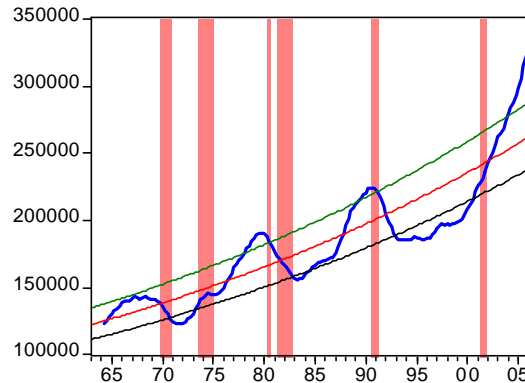
NORTHEAST 2.0% Trend Line



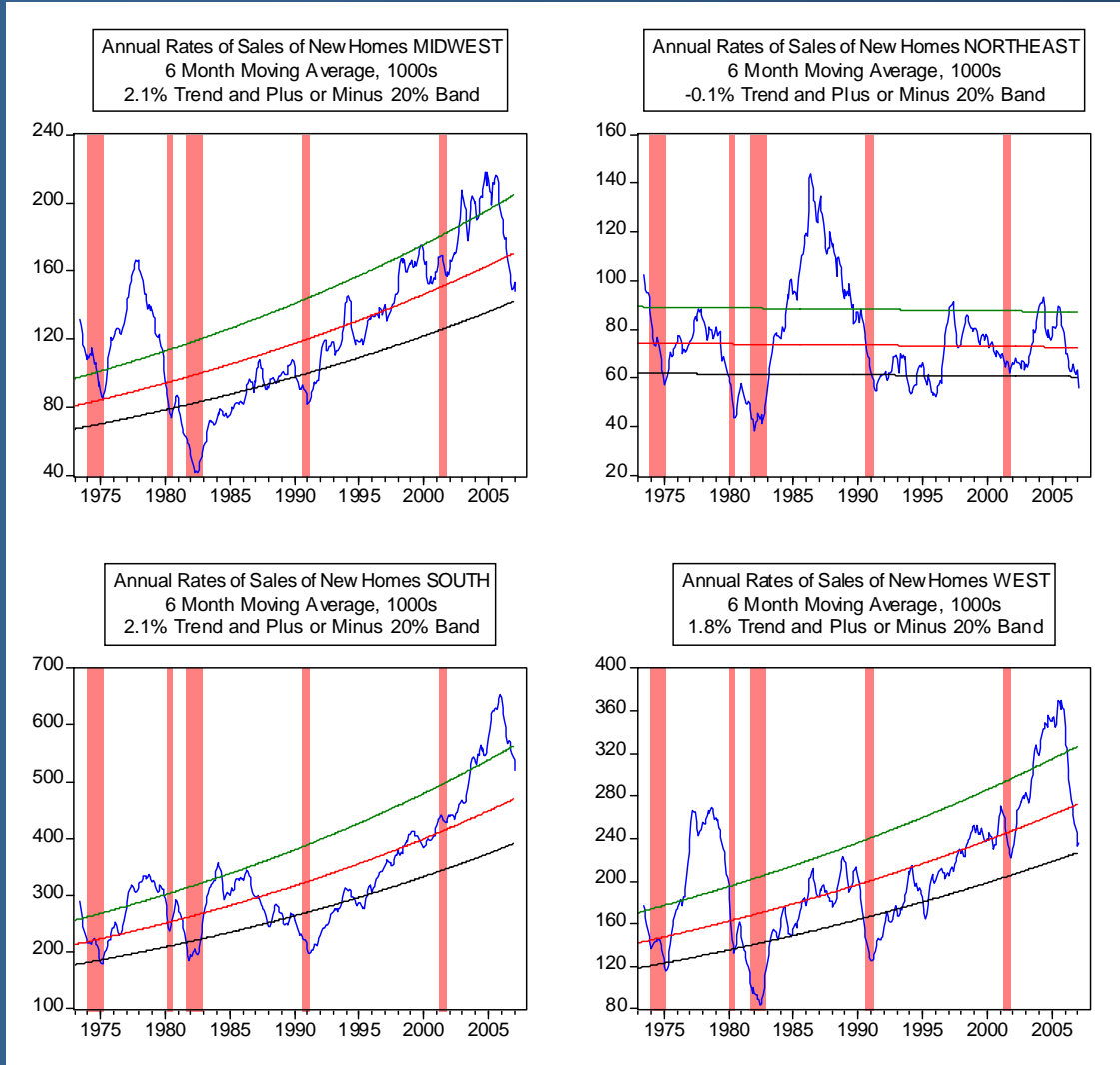
SOUTH 1.1% Trend Line



WEST 1.7% Trend Line



# Sales Volumes Really Decline: *It's a Volume Cycle, not a Price Cycle*



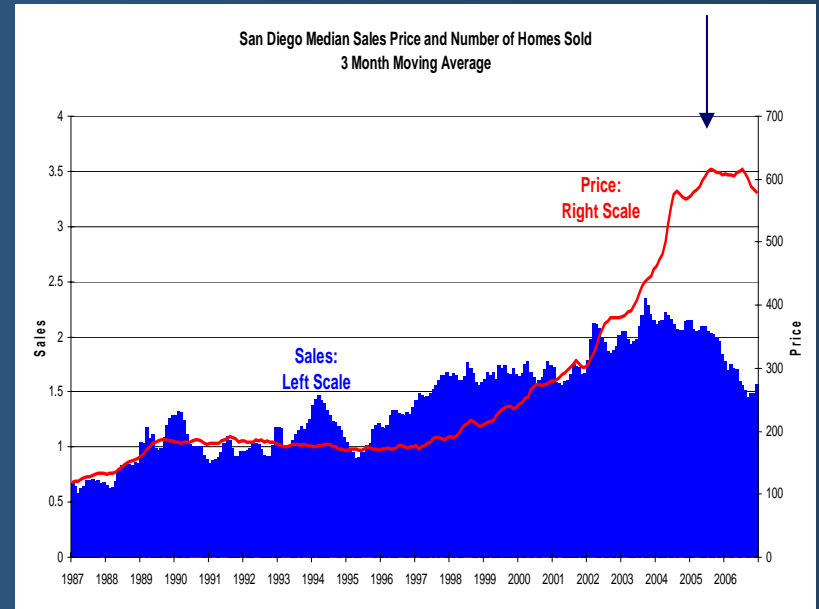
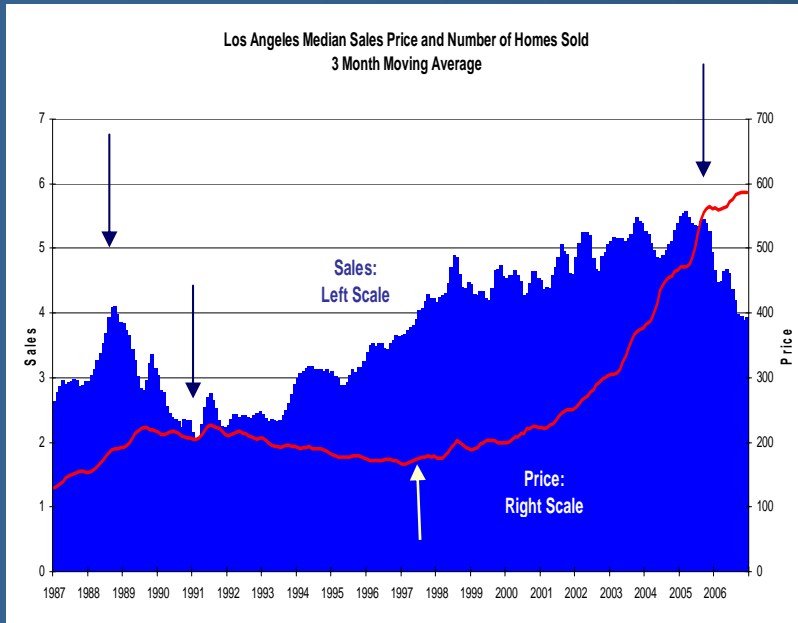
# Buyers Look Forward, and Sellers Look Backward, And They See Different Values



# Most CA Counties Look the Same

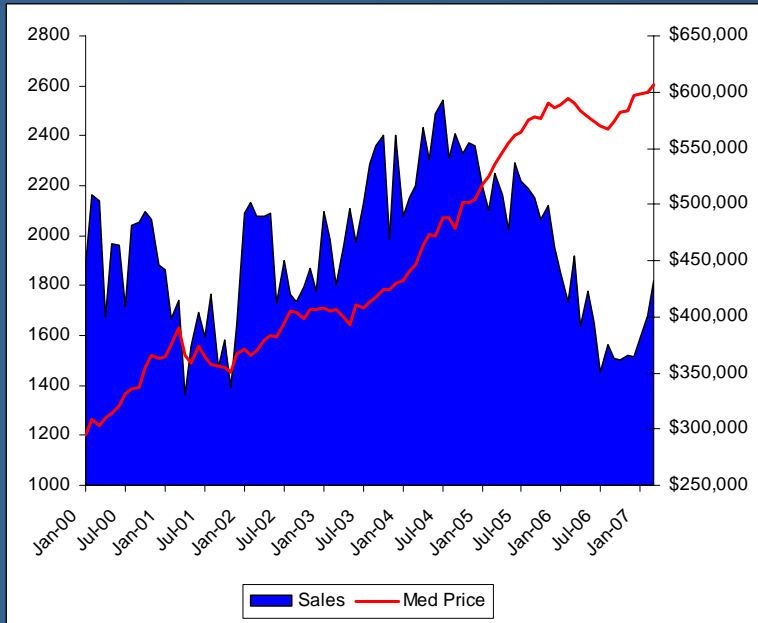
LA County Med. Sales Price (\$1000s SA, line) and Total Sales (1000s SA, area)

San Diego County Med. Sales Price (\$1000s SA, line) and Total Sales (1000s SA, area)

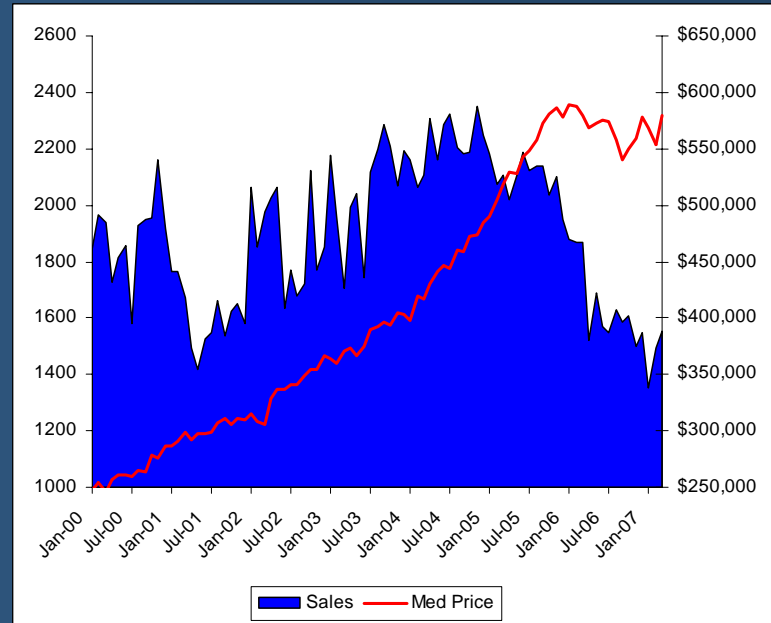


# Alameda is looking better

Alameda County Med. Sales Price (\$1000s SA, line) and Total Sales (1000s SA, area)

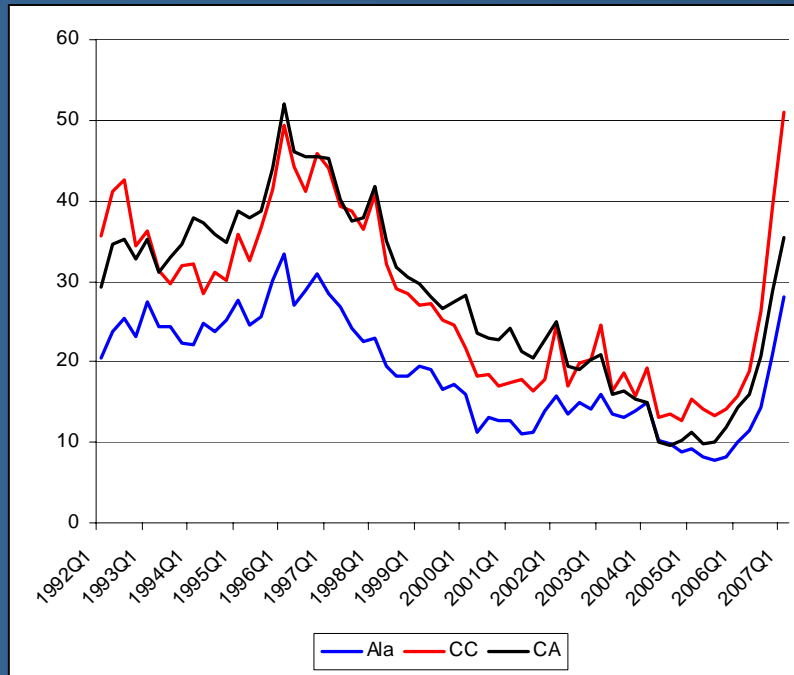


Contra Costa County Med. Sales Price (\$1000s SA, line) and Total Sales (1000s SA, area)

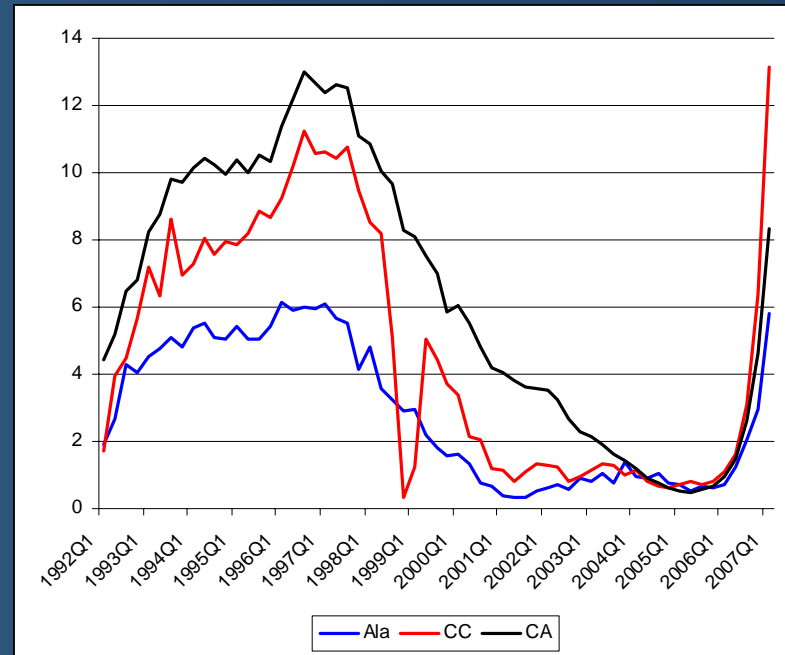


# Don't Get Too Overjoyed

*Notice of Mortgage Defaults  
per 10,000 Households*

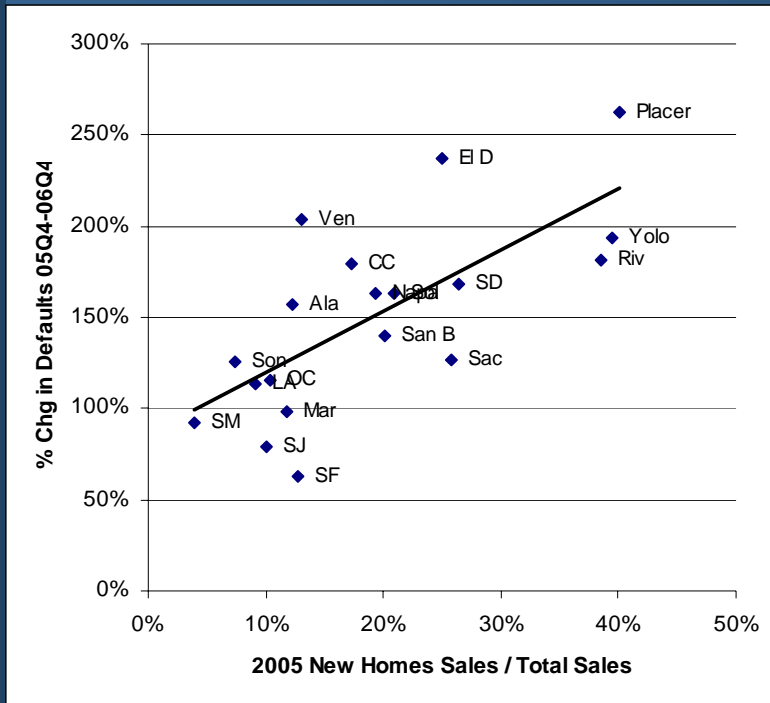


*Foreclosures  
per 10,000 Households*

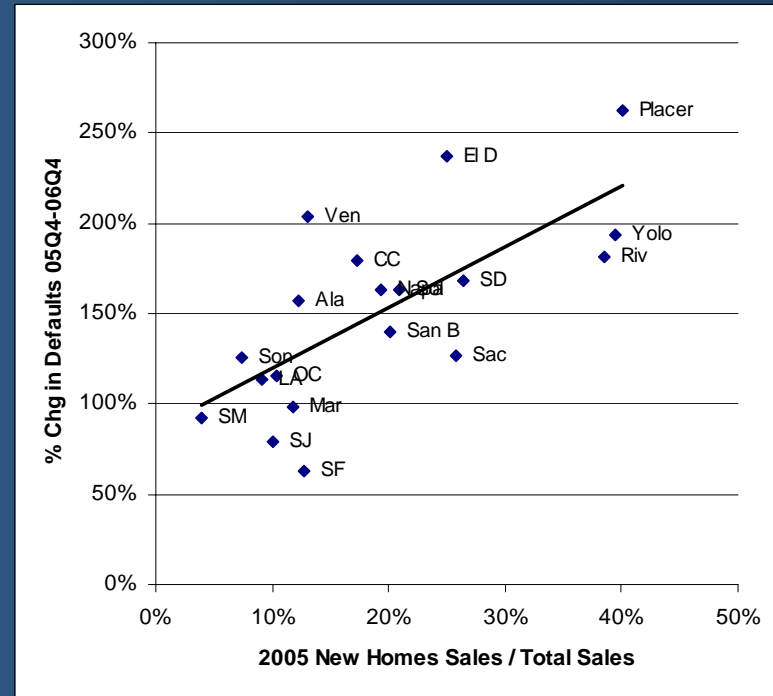


# New Homes are Leading the Way

## Increase in Delinquencies

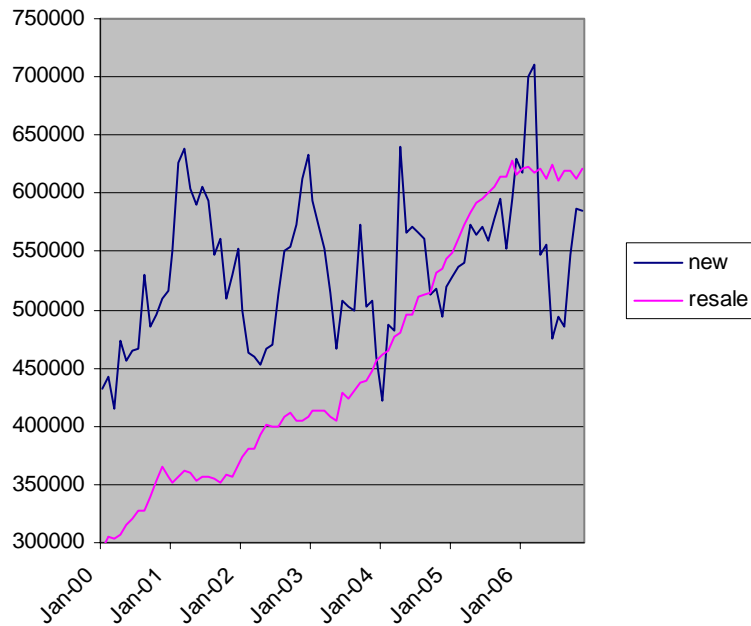


## Increase in Foreclosures

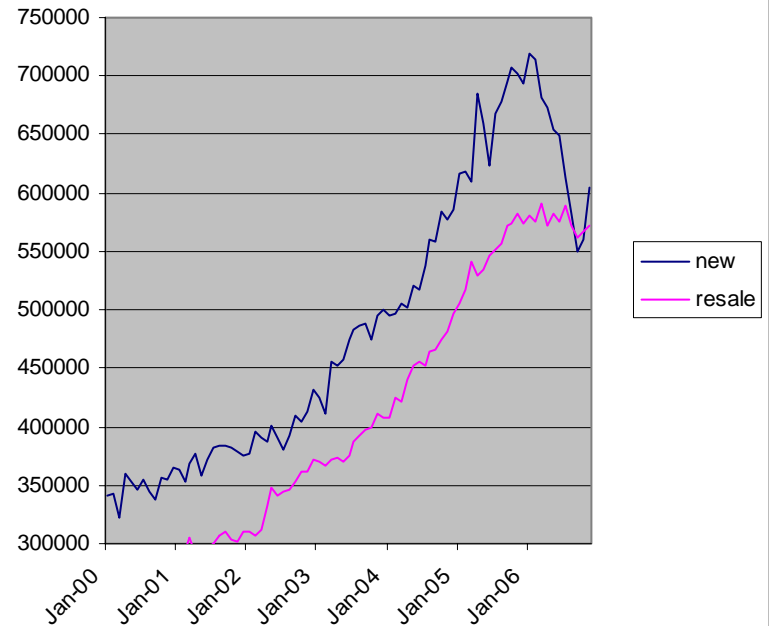


# New Home Prices Do Adjust

**Alameda Median Sales Prices of New and Existing Homes**



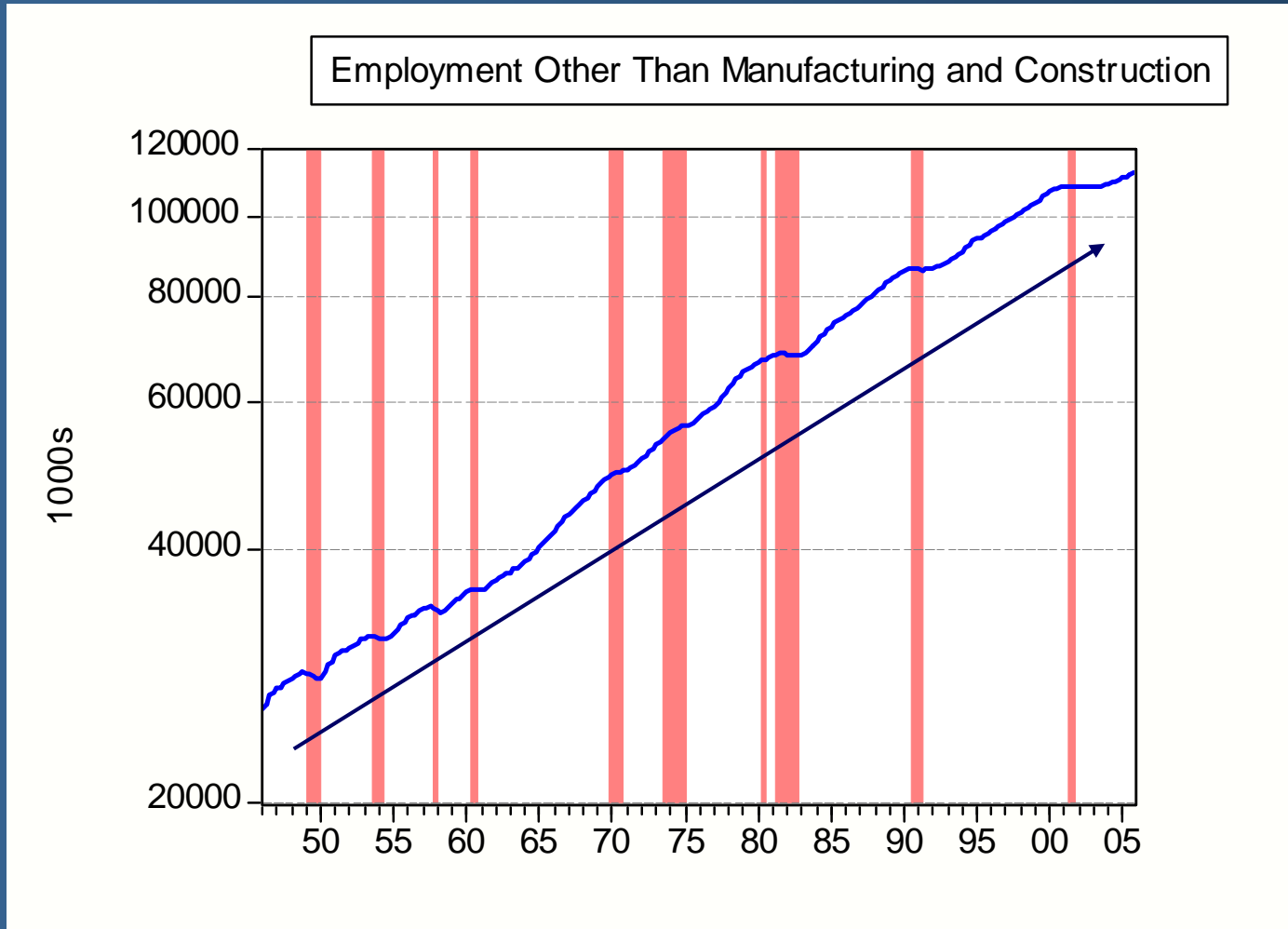
**Contra Costa Median Sales Prices of New and Existing Homes**



# Important Fact About Unwanted Idleness of Labor

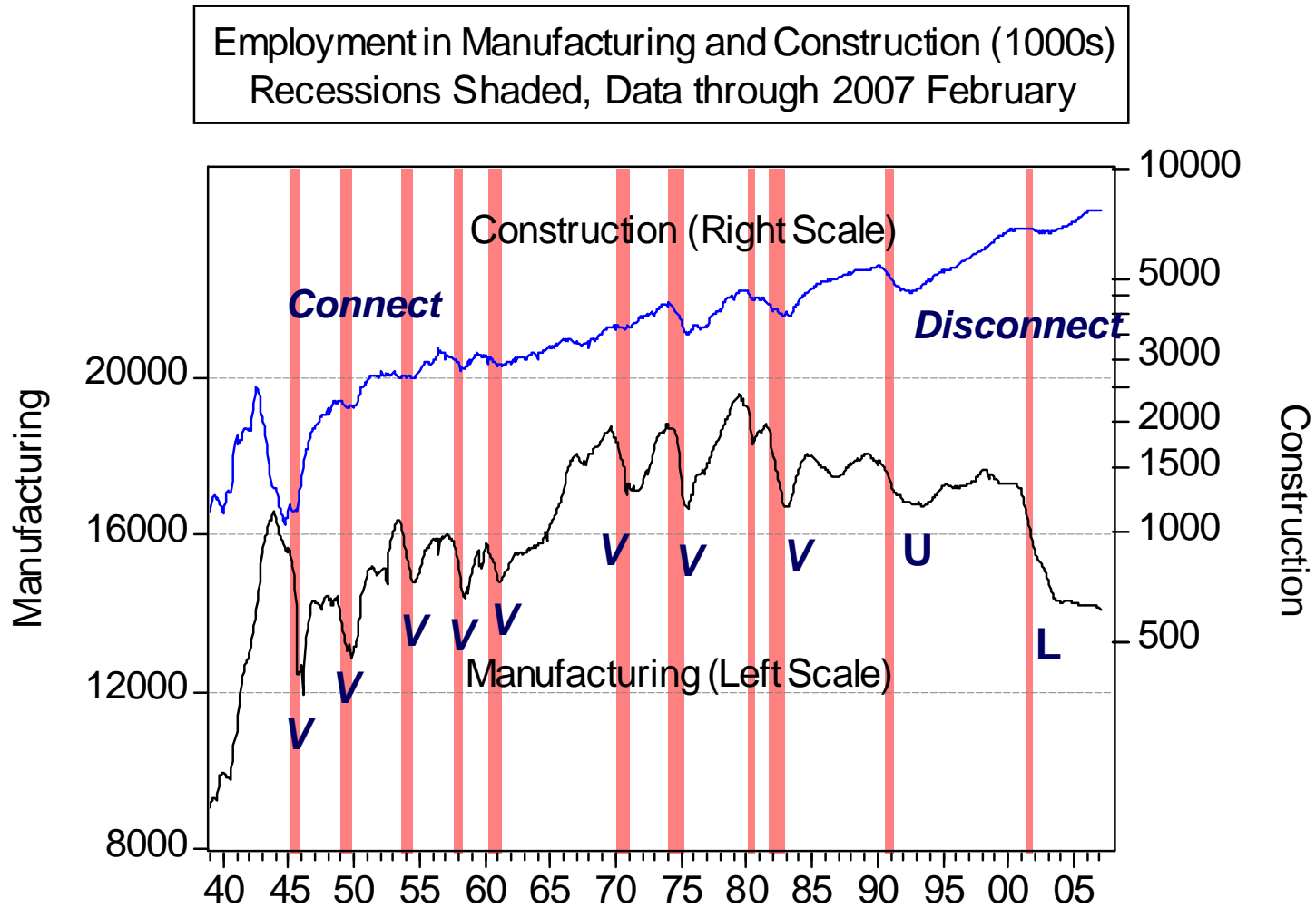
- ◆ Most of the job loss in recessions comes from two sectors:
  - Manufacturing
  - Construction

# Other Than Manufacturing and Construction, There is Hardly Any Job Loss



# This is the Forecasting Conundrum: Connect and Disconnect

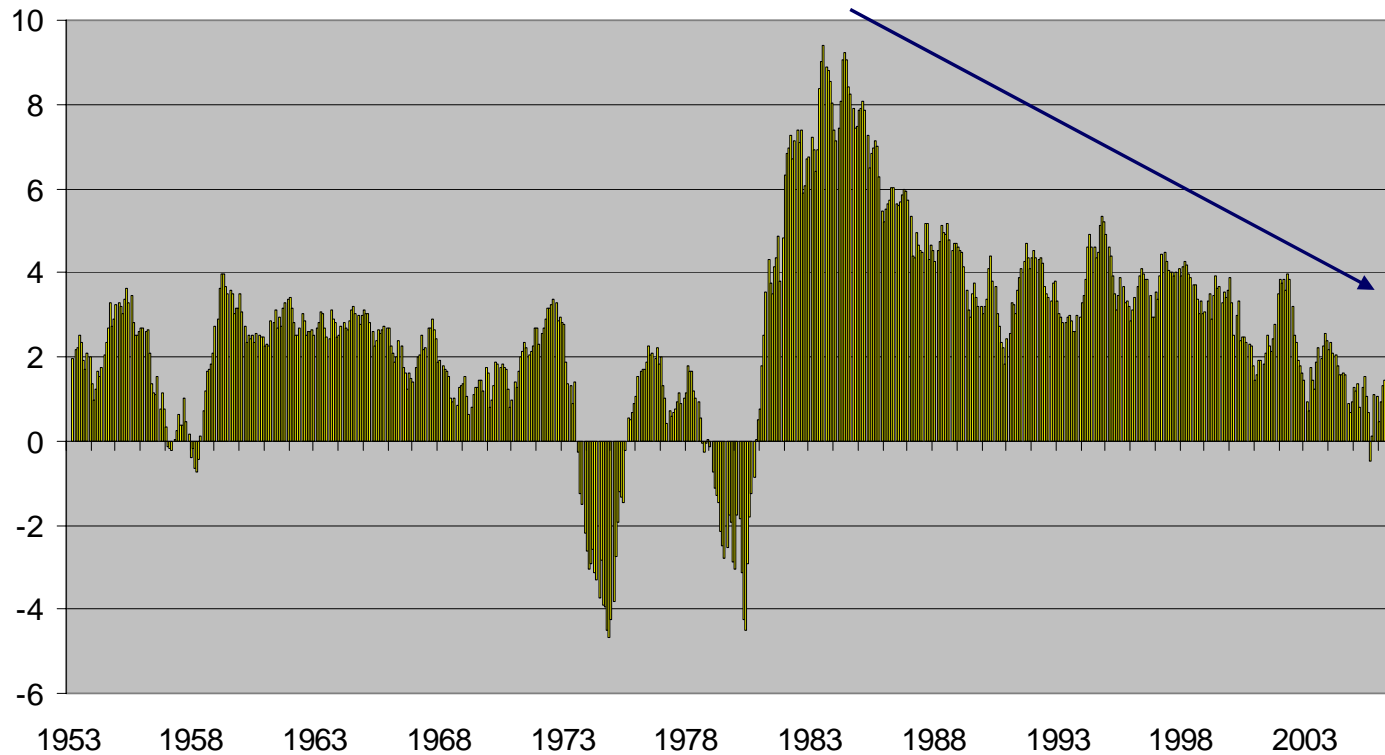
## Cycles in Employment in Manufacturing and Construction



# With Rates Like These, What, me worry?



Real Rates of Interest on US 10-Year Bonds



*December 2005*

## UCLA Forecast for 2006: A Housing Correction

- ◆ A Flat Yield Curve
  - Short-Term Rates Up to 5.25, and back down
  - 10-year Treasuries up to 5.5, and back down
- ◆ Weakness in Housing
  - Housing starts edge down from 1.9 m to 1.6 m by end of 2006
- ◆ Less than Normal Growth 2.1-3.0%
  - Housing Related Job Losses
  - Drag from negative wealth effect
- ◆ **NO RECESSION IN THE FORESEABLE FUTURE**

*December 2006*

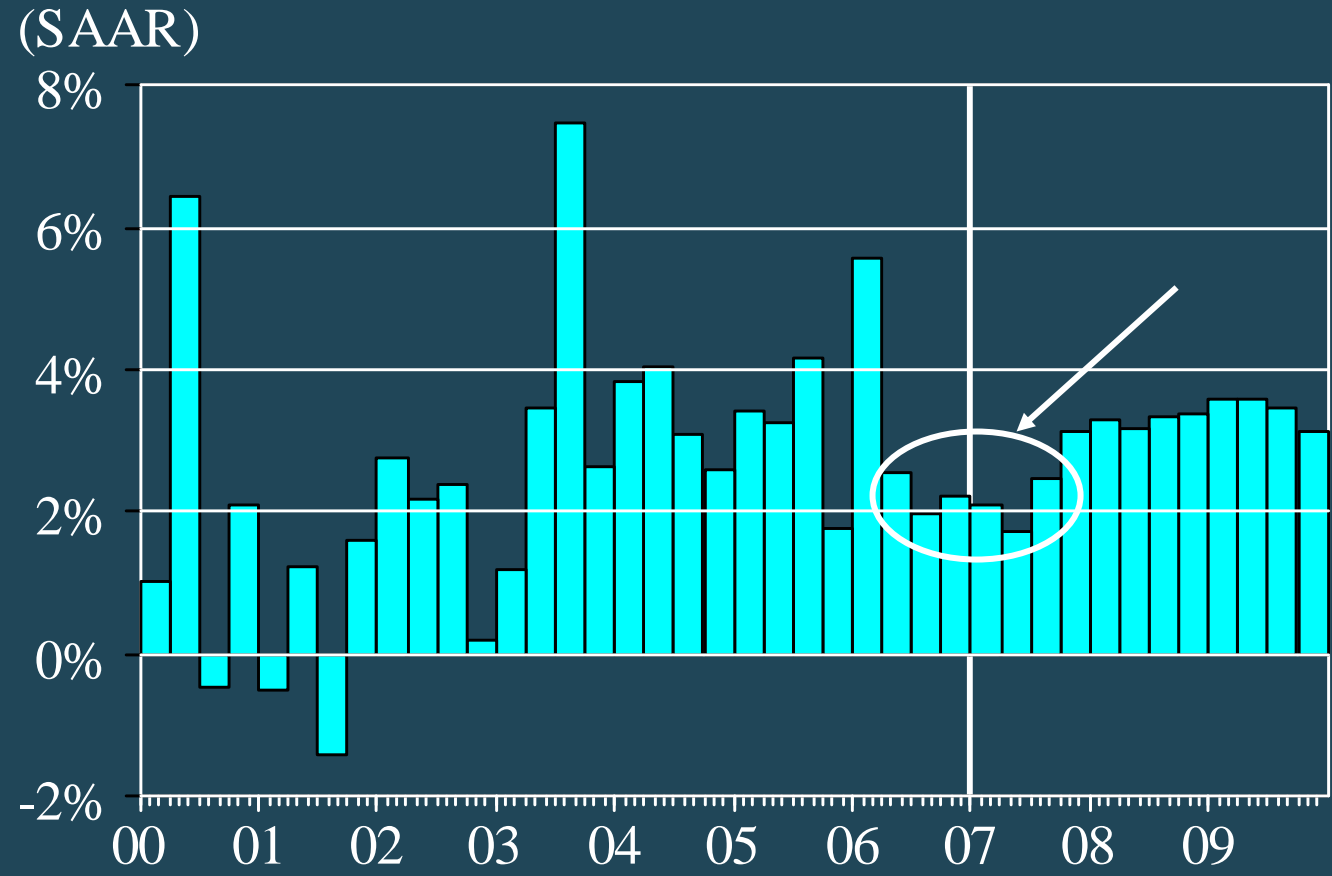
## Looking into 2007 and 2008

- ◆ Very Slow Growth Ahead, But No Recession
- ◆ Housing in Recession
- ◆ Pressure for Rate Cuts in '07
- ◆ 2008 OK

# Update, April 2007

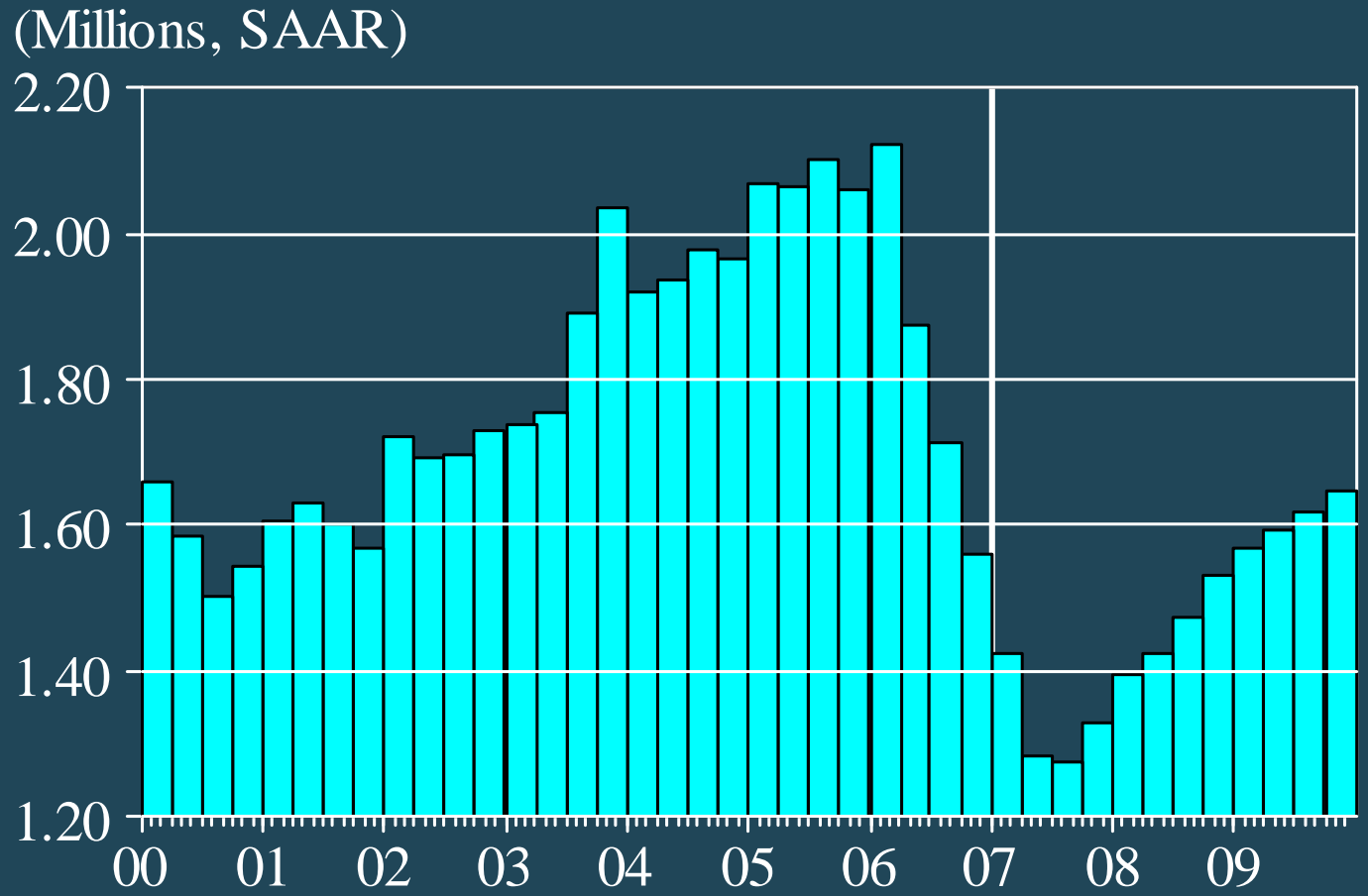
- ◆ Soft landing-no recession thesis intact, but risks have risen.
- ◆ 6 Quarters of below trend growth.
- ◆ Subprime debacle will cause a second leg down in the housing market.
- ◆ More pressure for Fed rate reductions
- ◆ International Trade and better-than-expected consumption keeps growth positive.

Figure 1. Real GDP Growth  
2000:Q1 - 2009:Q4



Source: Global Insight and UCLA Anderson Forecast

Figure 4. Housing Starts  
2000:Q1 - 2009:Q4



Source: Global Insight and UCLA Anderson Forecast

# Fed Doesn't Know What to Do

## March 20-21 minutes

- ◆ “The Committee agreed that further policy firming might prove necessary to foster lower inflation, but in light of the increased uncertainty about the outlook for both growth and inflation, the Committee also agreed that the statement should no longer cite only the possibility of further firming. Instead, the statement should indicate that future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information.”

# What About the East Bay?



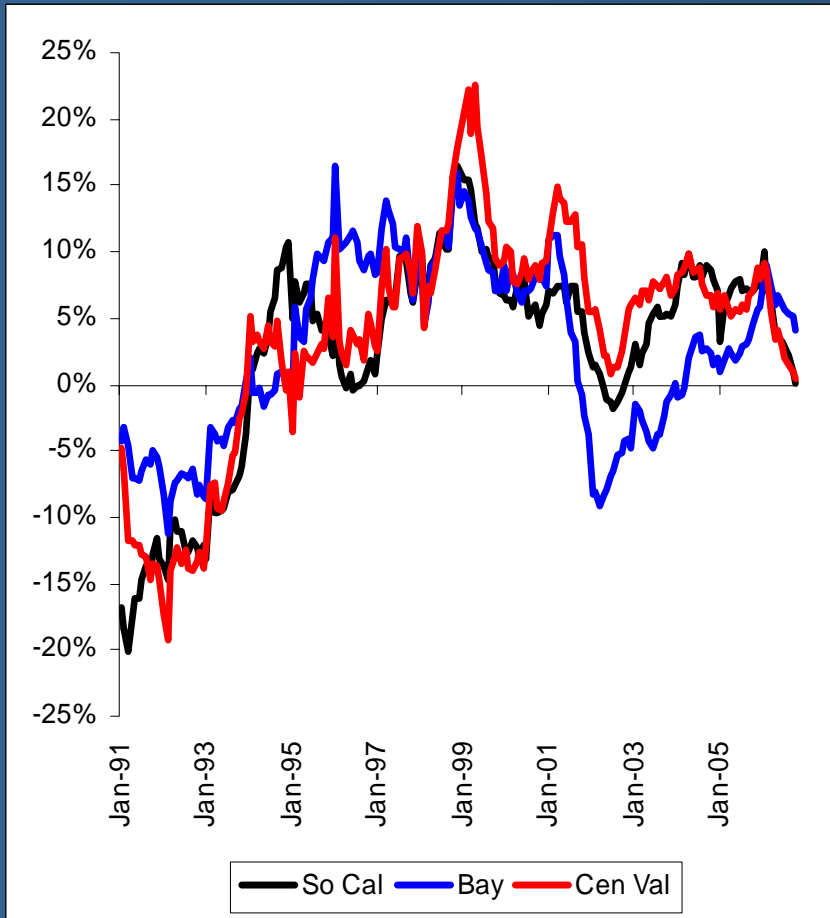
# Troubled Sectors?

**2005 Employment calculated from Quarterly Census of Employment and Wages Data**

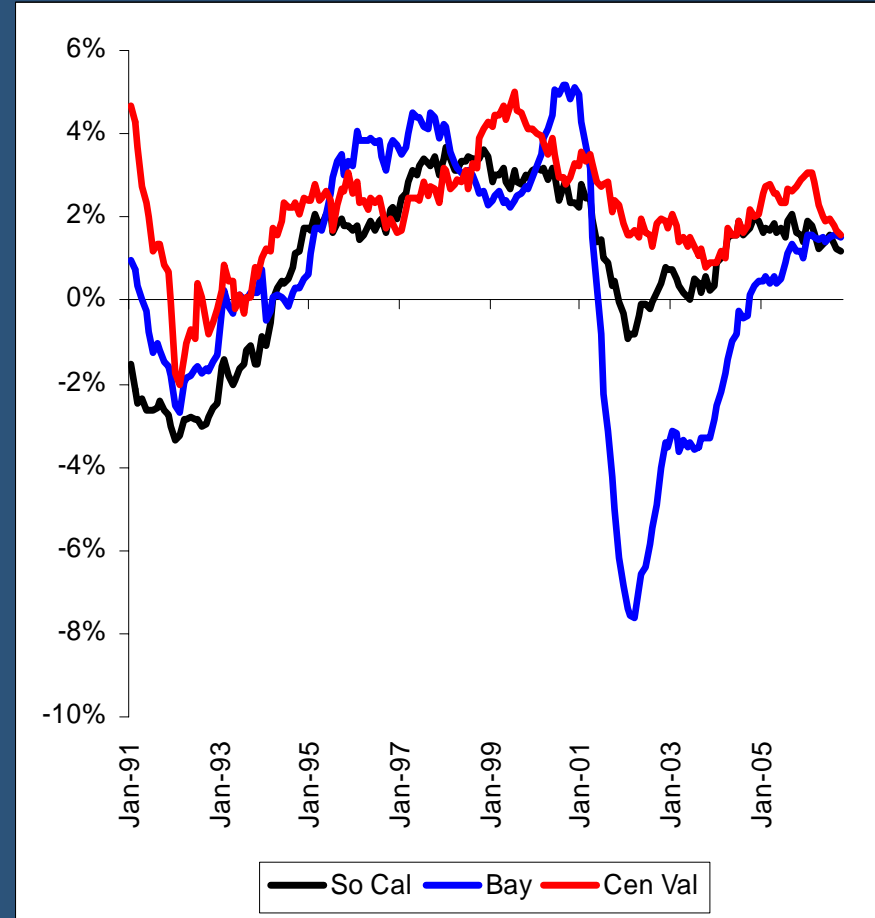
<b>Industry</b>	<b>U.S. TOTAL</b>	<b>California</b>	<b>Alameda County</b>	<b>Contra Costa County</b>
<b>Base Industry: Total, all industries (th)</b>	110,611	12,878	565	293
<b>NAICS 23 Construction</b>	6.6%	7.0%	7.7%	<b>10.1%</b>
<b>NAICS 31-33 Manufacturing</b>	12.8%	11.6%	<b>13.4%</b>	<b>6.8%</b>
<b>NAICS 52 Finance and insurance</b>	5.4%	5.0%	4.4%	<b>9.0%</b>
<b>NAICS 53 Real estate and rental and leasing</b>	1.9%	2.2%	2.0%	<b>2.6%</b>
<b>Total</b>	26.7%	25.8%	27.4%	28.5%

# Construction is a drag

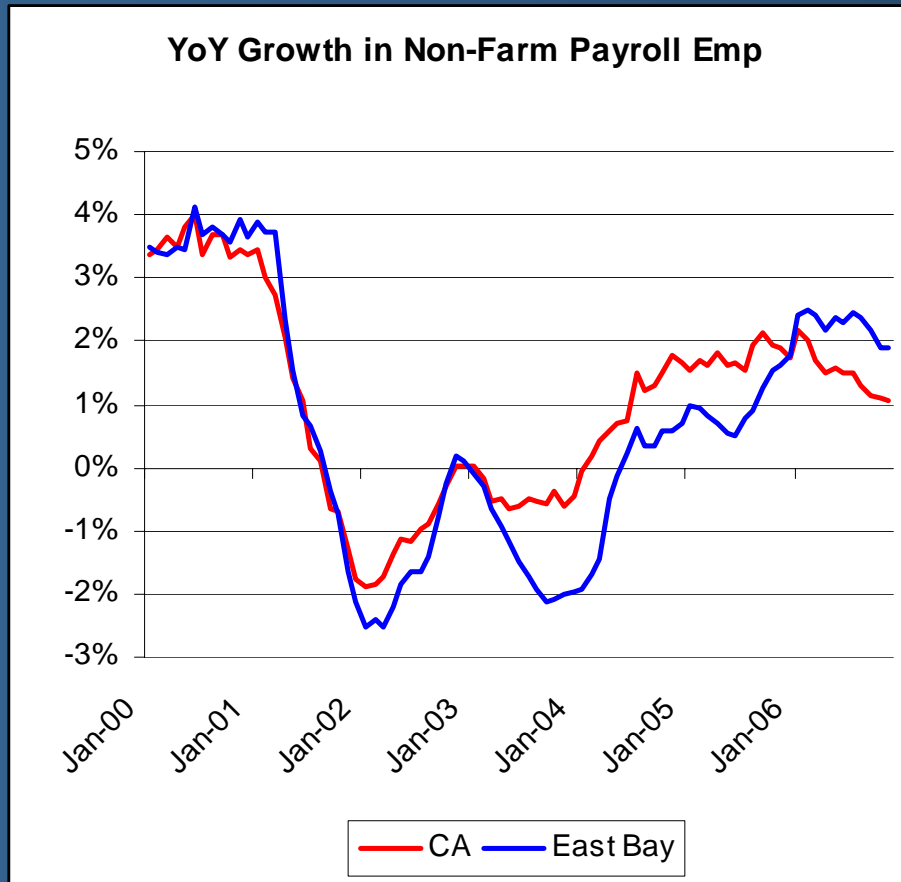
## Year-over-Year Growth in Construction Employment



## Year-over-Year Growth in Total NF Payroll Employment

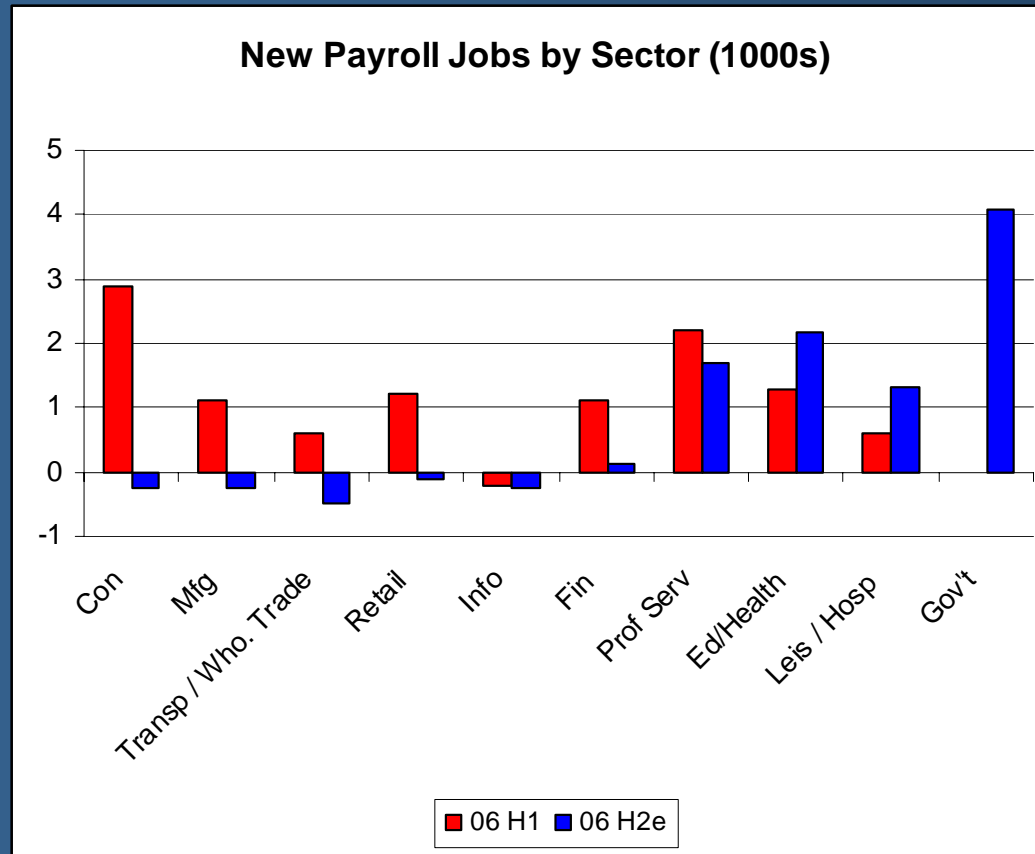


# The East Bay is Doing Better Than California Overall

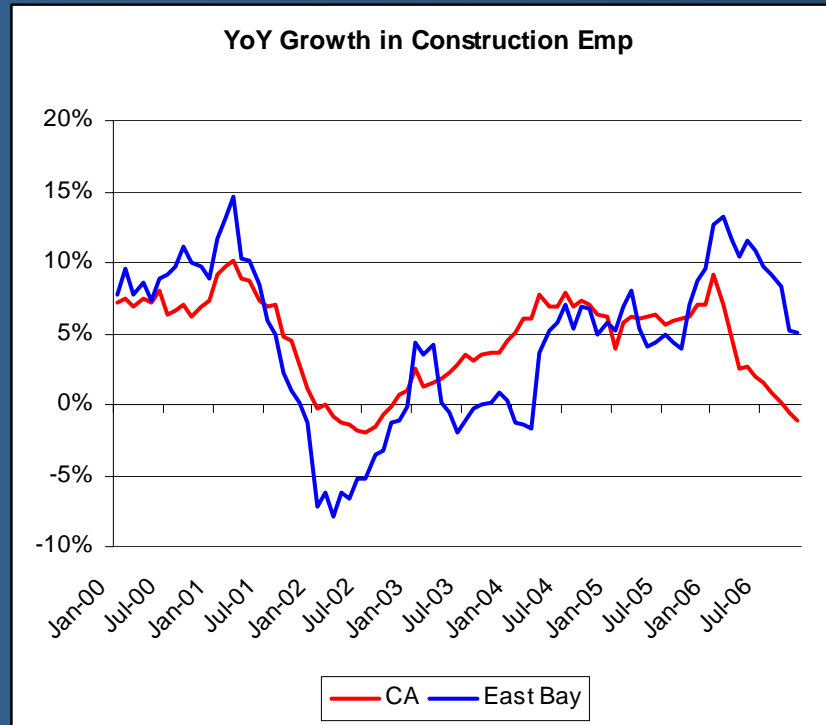


# But the devil is in the details

*The Source of East Bay Job Growth has changed ominously*



# But Construction Jobs are Not As Weak as California Overall



# *Don't Forget. It wasn't* Goldilocks and the Three Bulls



# *It was* Goldilocks and the Three Bears



# The End of the Goldilocks Economy

- ◆ Rising real rates of interest
- ◆ Sluggish revenues
- ◆ Weaker profit growth
- ◆ More volatility

And keep in mind, also:

The huge external deficit is a source of fragility, though it has been so for a very long time.

# The Message of the Subprime Mess: *The Regulators are:*



# Be alert

- ◆ Things could get worse quick.

