

## DAILY GLOBAL COMMENTARY

Northern Trust  
Global Economic Research  
50 South LaSalle  
Chicago, Illinois 60603  
northerntrust.com

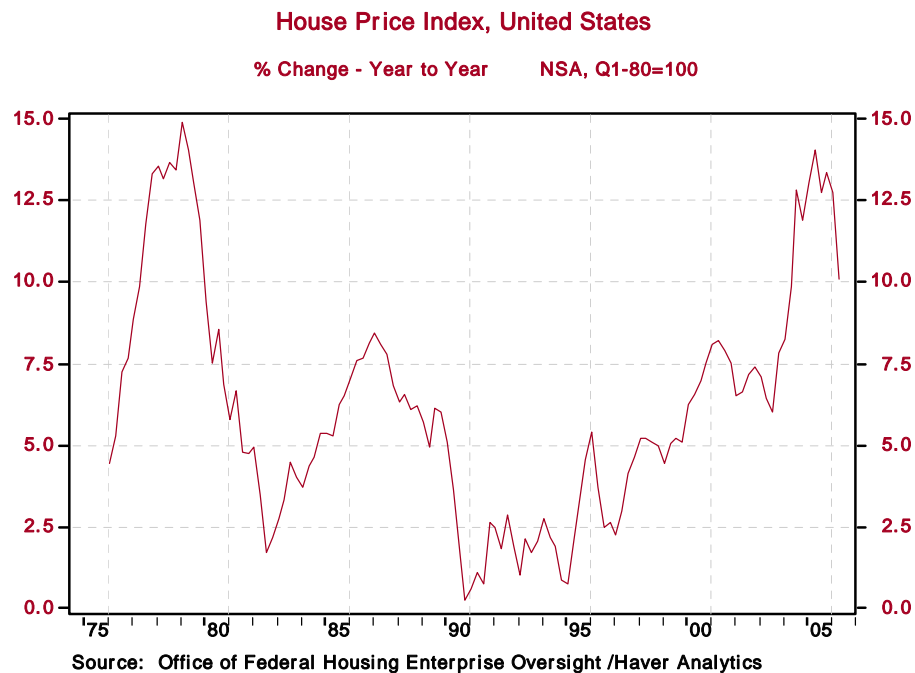
Asha Bangalore  
agb3@ntrs.com

### More Unpleasant News from the Housing Market

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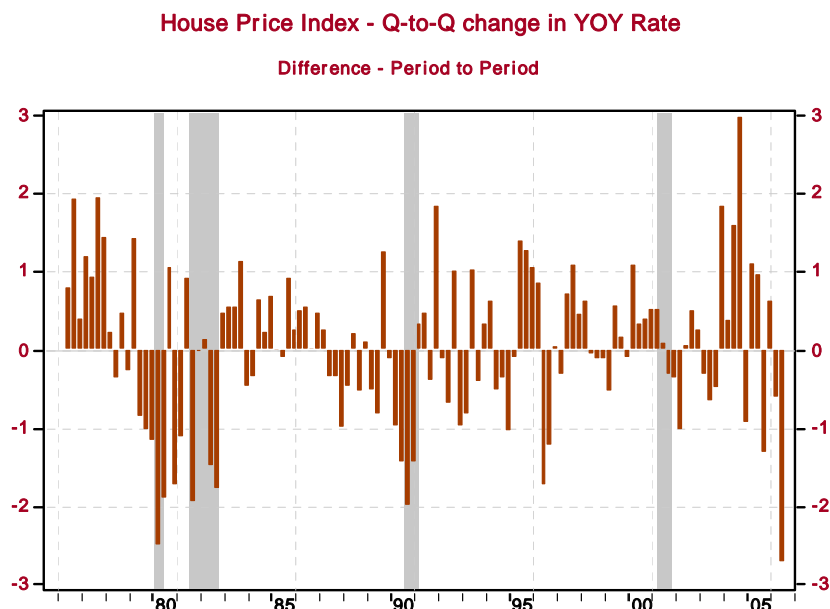
The House Price Index (HPI) continued to advance in the second quarter of 2006. However, the index shows a sharp deceleration on a year-to-year basis. The HPI rose 10.06% in the second quarter of 2006 compared with the HPI in the second quarter of 2005. The recent peak in the year-to-year change of HPI was in the fourth quarter of 2005 (+13.36%). Larger gains exceeding what we have seen in the current expansion were last reported in the late 1970s. In the first quarter of 1979, the HPI moved up nearly 15.0% (see chart 1) on a year-to-year basis. Following this peak, the HPI continued to show a decelerating trend until the third quarter of 1982 when the HPI posted a 1.68% increase on a year-to-year basis. In other words, it took a little over three years for home prices to turnaround.

Chart 1



At the present time, the sharpness of the deceleration is clear in Chart 2 which depicts the change in the year-to-year rate of change of the HPI. A decline of 2.7 percentage points in the second quarter vs. the first quarter is the largest since record keeping began for this price index (see chart 2). The upward trend of the number of unsold homes in the marketplace points to the possibility of a further deceleration in home prices.

Chart 2



Why is the housing market important? (1) As HPI decelerates, it reduces the amount available to households in the form of home equity withdrawals. (2) Inability to tap into home equity loans translates into slower growth of consumer spending. Also, as home price appreciation slows, households feel less wealthy and are likely to save and cut back on spending. (3) Consumer spending makes up two-thirds of GDP (In the current expansion consumer spending has exceeded 70.0% of GDP). Therefore, a big cut in consumer spending implies lower GDP growth. (4) A reversal of the positive ripple effects of housing market activity, which worked to lift growth across the economy, would lead to additional setbacks in GDP growth. (5) Last but not the least residential investment expenditures have already dropped for three consecutive quarters. Additional declines in this category of spending imply lower growth of GDP.

Housing market data suggest that the FOMC will be persuaded to watch and wait as the economy unfolds in the next few months before taking further action. The soft growth of payroll employment and decline in autos sales are other factors complimenting the weakness in housing and raising the probability of no change in the federal funds rate on September 20.

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