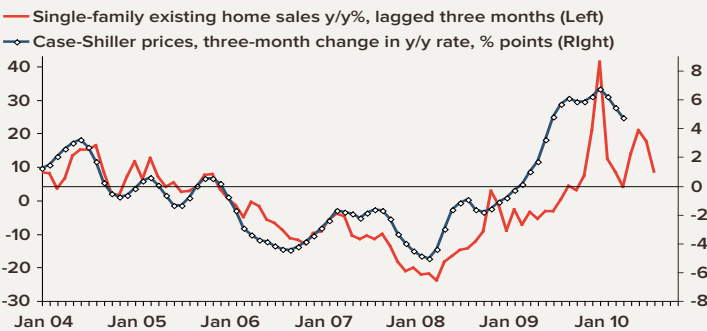




Home Prices Set To Slip, But Not Quite Yet

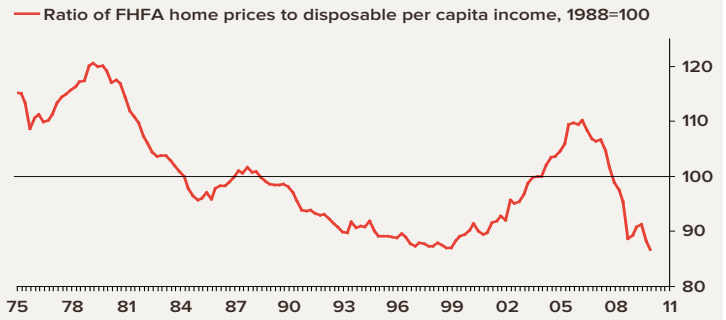
A decline in home prices through the summer and early fall is, in our view, just about inevitable in the wake of the collapse in housing market activity since the tax credit expired on April 30. *In the short term, movements in house prices are quite closely related to movements in home sales, with a lag of three months or so, as our first chart shows.* The lag means we do not expect to see prices decline in today's Case-Shiller home price report, which is for May. Remember that although the tax credit expired on April 30, people had until June 30—later extended to September 30—to close their transactions. *The price data are collected at the point of closing, so we don't expect to see reports of declines until the summer numbers are released in the fall.* Today, we expect a 0.5% gain for May. The consensus forecast for no change looks prematurely bearish to us.

Post-Tax Credit Drop In Sales Will Hit Prices...



More broadly, we think homes are now sensibly priced, overall, with our measure of the price-to-income ratio at its lowest level, just, since comparable data began 35 years ago. That is comforting in the context of thinking about the potential impact of the drop in home sales, because it suggests any further decline in prices will be modest relative to the plunge already recorded. **We see no chance of a re-**

...But Drop Will Be Modest As Homes Look Cheap



turn to the run of 20 straight 1%-plus declines in prices seen as the market collapsed between the fall of 2007 and the spring of 2009.

A really bad month or two cannot be ruled out, but we are inclined to expect a much more modest softening in prices. That should be enough to put affordability back at record levels, setting the scene for the start of a proper, though sluggish, recovery of activity in the fall.

Confidence To Slip, But Bottom Is Near

We are nervous about today's consumer confidence report from the Conference Board. In the past, the key expectations index from the survey—key because it leads consumers' spending, a bit—could be predicted from movements in the parallel index in the Michigan sentiment survey, which is released a couple of weeks earlier. But the previously close relationship between the two measures of expectations broke down in late 2007, when the market turmoil first began. More recently the two series have moved more or less back into line, but we don't know if this will prove permanent. *We have little else to go on, though, so we assume the Conference Board index dipped a bit further this month, bringing it into line with the Michigan survey.* Allowing for a modest incremental decline in the current conditions index too, the headline number should slide to about 50 from 52.9.

HFE's Economic Forecasts

GDP	Q4 final	5.6%	2007 year:	2.1%
	Q1 final	2.7%	2008 year:	0.4%
	Q2 forecast	2.5%	2009 year:	-2.4%
	Q3 forecast	2%	2010 year:	<3%
	Q4 forecast	2%		

CPI	Jun:	-0.1% (1.1% y/y); core 0.2% (0.9% y/y)
	Dec. 2010 forecast:	1.0% y/y; core 0.6% y/y
	Jun. 2011 forecast:	1.0% y/y; core 0.5% y/y

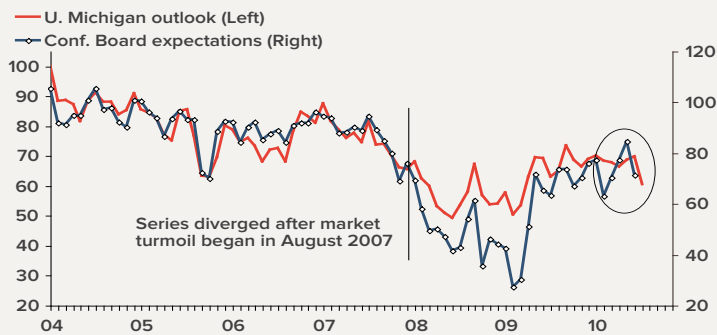
Unemployment: Dec 2010, 9.5%; Jun 2011, 9.0%
Federal budget FY 11 forecast: -\$1.1T (7.7% of GDP)

HFE's Financial Forecasts

		End-month:				
		4:30pm Monday	Sep	Dec	Mar	Jun
Fed funds	0-to-0.25	0-to-0.25 through Dec 11				
2-yr	0.59	0.75	0.75	0.75	0.75	
10-yr	2.99	3.00	2.75	2.50	2.50	
30-yr	4.01	3.75	3.50	3.25	3.25	
Curve 10-2	240	225	200	175	175	
Curve 30-2	342	300	275	250	250	
Dow Jones IA	10525	10250	10250	10500	10750	

Dollar: Euro sinks to new lows, sterling recovers a bit. C\$ to rise on BoC decision. Yen rising. No big yuan adjustment, just noise.

Confidence Numbers Back In Line?



The good news is that we do not regard the drop in confidence over the past month or two as the start of a renewed downward trend. It is, in our view, a reaction to the drop in stock prices between early May and early July. Stock prices, along with gasoline prices, are the key drivers of consumers' expectations, and a decline was inevitable after the market rolled over. But the S&P 500 is now back to its mid-May level, and we do not expect further sustained declines. U.S. equities, in our view, are now fairly valued, even in the context of a slowdown in growth in the second half of the year. *That should mean no further significant decline in confidence, and even a decent chance of a modest rebound in the August or September numbers.* Either way, the data will remain consistent with sluggish growth in consumers' spending, but not a relapse into recession.

So far, the chain store sales numbers seem to support that view, though the year-over-year rate of growth in the Redbook survey slipped almost to the bottom of its recent range last week. Sales were up a respectable 2.7%, but the previous couple of weeks were slightly better. It is always dangerous to read too much into the weekly numbers, because they can be pushed off trend by innumerable temporary factors. *The heatwave in the eastern half of the country, for example, may have acted as a temporary disincentive to shoppers.* Over the next few weeks, a sustained downshift to Redbook sales growth of 2-to-2.5% or so would be consistent with the drop in confidence in the wake of the correction in stocks. Consistent is not the same as welcome, however, and weak numbers at the start of the third quarter, coupled with a sluggish end to the second, would make it difficult for real consumption to match the 2.5% quarterly annualized rate we expect to see reported for the second quarter on Friday this week.

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This Week's Funding

Mon	Auction—\$30B 3-month, \$30B 6-month bills Announcement—4-week bills (July 27)
Tue	Auction—4-week bills Auction—\$25B 52-week bills Auction—\$38B 2-year notes (settles August 2)
Wed	Auction—\$37B 5-year notes (settles August 2)
Thu	Announcement—3-month, 6-month bills (August 3) Auction—\$29B 7-year notes (settles August 2)

This Week in Brief

Note: "SS" prefix denotes Snapshot for these data.

Monday, July 26

- **SS: New Home Sales (6)/10:00 EDT**
Sales rebounded to a still-pitiful **330K** after a downwardly revised plunge to a record low of 267K in May.

Tuesday, July 27

- **Redbook Chain Store Sales (7/24)/9:00 EDT**
Sales growth should be close to last week's **2.7%** year-over-year; the numbers are range-bound.
- **SS: Case-Shiller Home Prices (5)/9:00 EDT**
Prices were likely boosted by the rush of demand under the tax credit; we expect a **0.5%** gain. **Consensus: 0.0%.**
- **SS: Consumer Confidence (7)/10:00 EDT**
The drop in the Michigan index suggests the Conference Board number will fall to **50** from 52.9. **Consensus: 51.8.**

Wednesday, July 28

- **SS: Durable Goods (6)/8:30 EDT**
Total orders should rise about **2%**, boosted by a rebound in aircraft orders. Ex-transport, we expect a **0.5%** increase. **Consensus: Orders 0.8%, ex-transport 0.5%.**
- **MBA Mortgage Applications (7/23)/7:00 EDT**
Applications are at rock-bottom, but we hope that record low rates will lift the purchase applications index from last week's **168.9**. Refis should rise again too.

Thursday, July 29

- **SS: Initial Jobless Claims (7/24)/8:30 EDT**
Claims should be close to last week's **464K**, though seasonal issues mean anything could happen. **Consensus: 460K.**
- **Federal Reserve Beige Book/14:00 EDT**
Patchy recovery continues; how widespread is evidence of softening?

Friday, July 30

- **SS: GDP (Q2 advance)/8:30 EDT**
Growth should be about **2.5%**. Consumption likely rose 2.5%, but the key number is capital spending on equipment and software, which we think jumped by about 18%. Investment in housing should be up 16%, with non-residential structures steady. Government spending probably climbed about 1%. We expect a \$65B increase in inventories, adding 0.7 percentage points to growth. Exports likely rose 9%, but with imports up 21% trade likely subtracted 2.0 points from growth. The headline deflator should be up **0.9%**. **Consensus: GDP 2.5%, deflator 1.1%.**
- **SS: Employment Cost Index (Q2)/8:30 EDT**
Costs should rise **0.5%**, a bit slower than the first quarter's benefit-driven 0.6% gain. **Consensus: 0.5%.**
- **SS: Chicago PMI (7)/9:45 EDT**
The headline index should slip marginally to about **57** from 59.1. **Consensus: 56.0.**
- **Univ. of Michigan Consumer Sentiment (7f)/9:55 EDT**
The final reading for July should be close to the preliminary **66.5**, down from June's 76.0. **Consensus: 67.5.**