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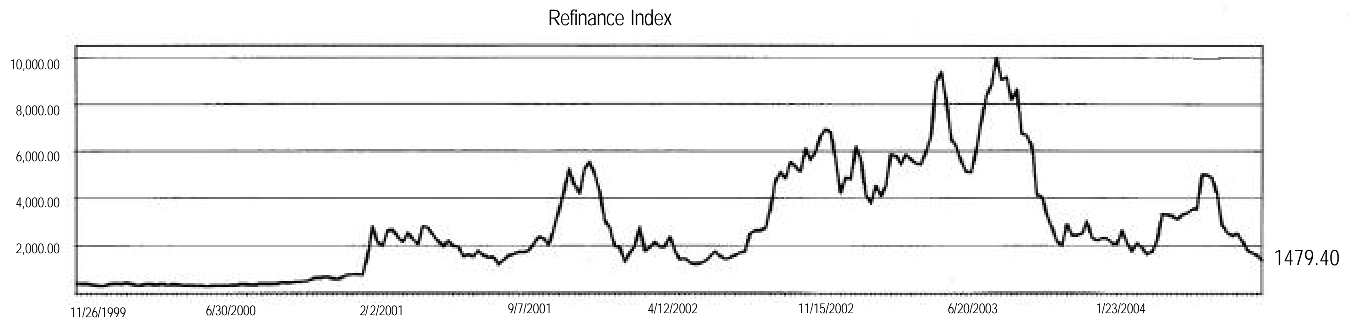
Refi's vs. Job Growth

Fiscal and monetary policies have been very stimulative over the last eighteen months. The Bush tax cuts have been in effect for about a year, giving households more after-tax dollars to spend. During this time, the Federal Reserve has kept short-term interest rates at almost nothing. Lower rates have given consumers a once-in-a-lifetime opportunity to restructure their finances by refinancing their mortgage loans. As the chart below shows, households have taken advantage of this opportunity in record numbers since the end of 2002.



Low interest rates have probably been even more important than tax cuts in stimulating the economy. As homeowners refinanced, they have saved hundreds of dollars a month on their mortgage payments. In addition, the low rates made it cheaper to buy housing rather than rent, thus adding stimulus to the housing market. In fact, today over 70% of U.S. families own their homes.

As interest rates have begun to rise, however, refinancings have slowed and appear likely to return to the levels of the 1990's. The end of the refi binge will impact consumers in two ways, neither of which are good for incremental economic growth. First, with mortgage rates where they are, further refinancings don't make economic sense. Households will continue to reap the benefits of last year's refinancings, but on the margin, there will not be further savings to stimulate consumer spending. Second, a larger number of these refinancings and new home purchases have utilized adjustable rate mortgages, taking advantage of the large difference between short rates and long rates. But, to the extent that the Federal Reserve raises short-term rates, monthly payments on these adjustable rate mortgages will rise dramatically. Even if rates rise only 2.5 percentage points, the monthly payments on a $200,000 mortgage will increase over $400.

Add to the mortgage issues higher energy prices and no further tax cuts in sight, and it is a fair bet that consumer spending will not be as robust in the next twelve months as it was over the last 12-18 months.

Job growth is the good news. Job creation has certainly picked up in the last few months. In past cycles, job growth increased household income enough to offset higher consumer interest rates. But we've never had a cycle of refinancings like this. And we've never had so many homes financed with floating rate loans. My guess is that employment won't grow enough in the next year to offset the depressing effects from mortgages. Thus the forecasts for GDP and corporate profit growth next year are probably a bit too high, and price/earnings multiples are a bit higher than they appear.

The stock market can do okay in such a scenario. Higher quality, less cyclical stocks will probably have better relative performance than those that lead the market coming out of the recession.

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A copy of our Form ADV, Part II is available upon request.
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