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BEWARE OF THE CONTAGION EFFECT !

Wall Street indices are going through the proverbial roof, day after day after day: Nine consecutive days of record-breaking gains, ended last Tuesday.

US investors continue to buy into stocks and shares, listed on US equity markets, with every coming new historic high of The Dow Jones Industrial Average or the Composite Index of The NASDAQ.

It is as though there were no ceiling for these indices.

But the volumes of activity on the world's largest equity markets are not high, relative to the same period about one year ago: Such a situation is not indicative of a sustainable, bullish market.

And the US housing market continues to decline ... as **TARGET** () predicted some time ago.

TARGET continues to maintain its stance in respect of the US economy: It is headed for a hard landing, the way that things stand today, regardless of protestations to the contrary.

Wall Street gurus may be successful in talking up key indices of The New York Stock Exchange and the Composite Index of The (tech-laden) NASDAQ for a time, but, somewhere down the line – and **TARGET** feels that it could be sooner, rather than later – the penny will drop.

The situation, today, suggests, strongly, that there could well be a resurgence of the contagion effect on other economies of the world in the event that the US housing market continues to head south at its current pace.

According to The National Association of Realtors, a US-based organisation, which is well respected for its insights into the US housing market, The House Price Index has fallen from double-digit rates to negative figures in the course of just 4 months.

It is the sharpest decline in the past 40 years.

That is not the entire picture, however, because one must, also, take into consideration that the Year-On-Year comparison calculation omits the seasonally adjusted House Price Index.

It is popular, these days, to compare one quarter's results of a company with another quarter's, or one quarter's results with the like quarter, one year earlier, but muddying the waters is when one seasonally adjusts the growth level of an industry with regard to a specific period of time, such as the US housing industry, and, then, makes an adjusted comparison with the like period one year earlier.

TARGET did, exactly, that and discovered that the US housing market has been on the slippery slopes since November 2005.

And that is scary.

Dr Alan Greenspan, the former Chairman of the US Federal Reserve, warned, on numerous occasions, that there was a real danger to the US economy from what he saw as the potential for a partial collapse of the US housing market.

It has come to pass.

Today, Europe is watching the US housing market closely because it is seen that, due to macroeconomic interdependencies of the US and European economies, that which affects the US housing market could be exported to European economies – the contagion effect.

The interdependency between exports and financial markets cannot be overlooked.

If the US housing market continues to fall, appreciably, as **TARGET** has stated, many times in the past, then consumer spending will start to dry up, exporters and importers will be hit, and, eventually, Europe will feel the effect of the problems in the US market.

The snowball effect will, undoubtedly, hit the housing markets from France to the eastern tips of the European Union.

Last Tuesday, the US Federal Reserve released its findings with regard to industrial production and capacity utilisation.

The following are the first 2 paragraphs of that release:

> *'Industrial production decreased 0.6 percent in September after having been unchanged in August. For the third quarter as a whole, industrial production rose at an annual rate of 3.6 percent, down from the rapid pace of gains in the previous three quarters. Nonetheless, production at the end of the quarter was about 5-1/2 percent above its year-earlier level. Output in the manufacturing sector declined 0.3 percent in September, a decrease that slightly more than reversed its upwardly revised gain of 0.2 percent in August. The output of utilities plunged 4.4 percent in September, while the output at mines expanded 0.7 percent.*
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> *'Capacity utilization for total industry declined 0.6 percentage point, to 81.9 percent. Even so, this rate of capacity utilization was higher than the rates recorded from mid-2000 to early 2006 …'*

A continual weakening of the US housing market must, eventually, lead to weaker US **G**ross **D**omestic **P**roduct (GDP) – the total value of goods produced and services provided in a country, excluding transactions with other countries.

Such a scenario leads one to realise that the prospects are for Europe's economies to feel the brunt of the economic problems of the US, down the road, and it is quite likely to cascade into Asia in short order.

Lower Incomes Lead To Accelerating House-Price Falls

Lower incomes, of course, mean lower prices for houses, leading to accelerating house-price falls.

It is only common sense.

It is, now, well established that house prices in the US move in synchronisation with house prices in most parts of Europe.

This contagion effect could well help to increase the rate of fall in the prices of houses in Europe as US house prices fall lower.

In the past decade, statistics show that house prices in the US have more than doubled.

In Europe, however, in the past decade, house prices have risen even further than in the US: In Spain, house prices have risen by about 150 percent; in the United Kingdom, house prices have risen by more than 200 percent; and, in Ireland, house prices have scooted up by more than 300 percent.

Of course, different economic factors have determined the rate of increase in the price of houses in Europe and these factors, obviously, will continue to do so.

However, enter the synchronisation factor, coupled with the contagion effect of the fall in the price of houses in the US.

It is obvious and hardly justifies repeating that falling interest rates and rising incomes signal easier conditions to finance a home.

Conversely, unsustainable house prices are reached when the rising price of houses are outpaced by falling interest rates and rising incomes over a number of years.

Since 1998, the affordability of houses in many countries has deteriorated.

In the past 8 years, for instance, in the United Kingdom, France and the Netherlands, the affordability of houses has fallen by about 40 percent.

In certain parts of Europe, housing has become a major problem because the prices are out of the reach of many a family.

With the US housing market, running hot a few years ago, Europe got caught up in the frenzy – the contagion effect – and house-price appreciation in Europe followed that of The Land of The Free and The Home of The Brave.

Very soon, the situation is likely to be in reverse.

Higher interest rates, around the world, will have a telling effect on the price of houses, from Dublin, Ireland, to Paris, France, to New York, to Los Angeles, California, to Tokyo, Japan.

The contagion effect is likely to reach far and wide.

The measure of the contagion effect, however, will depend on certain economic elasticities and, especially, of the elasticity of the price movements in the US with the elasticity of the price movements in Europe.

With every statistic, being released by US Government agencies, statistics, indicating that the US economy is continuing to weaken, so will the housing market follow suit, causing consumer spending to continue to dry up, resulting in more financial trouble in store.

Asia is unlikely to be immune from these very contagious effects.

For More About The US Economy, Please See:
TARGET Intelligence Report, Volume VIII, Number 180,
Published On September 29, 2006 Headlined:
'***IS THERE A FLY IN THE PICKLE BARREL ?***'

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