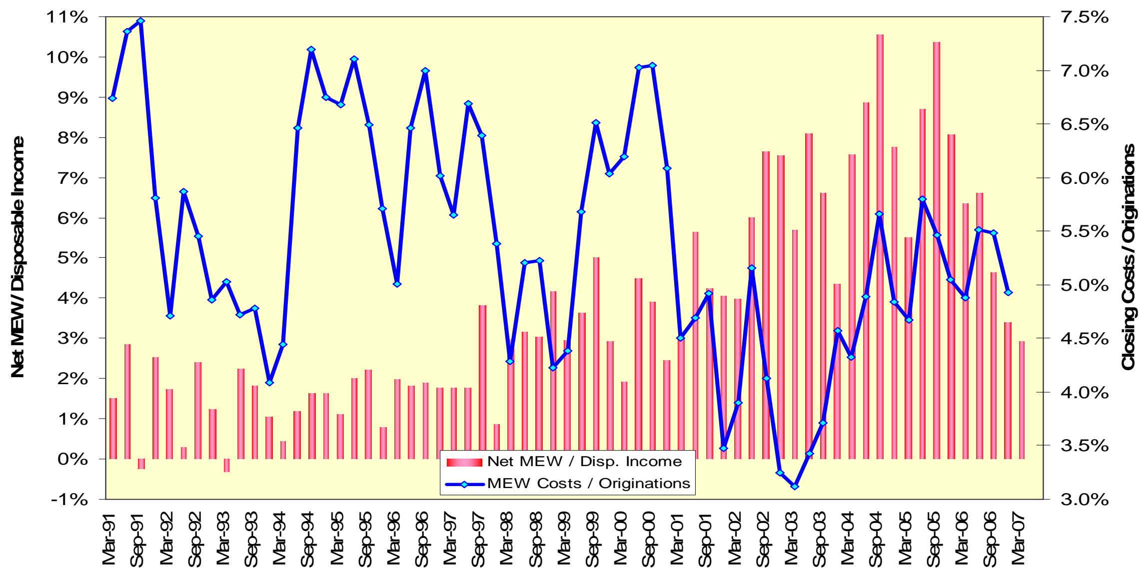
MEW And You

Anyone who has spent more than fifteen minutes in Washington, D.C., knows anything can be turned into an acronym. On occasion, some such as SNAFU pass into the general idiom; more often, however, they fall by the wayside. The Federal Reserve seldom is a culprit in this abuse of the English language; it is run by economists, after all, so their last focus is generating some catchy little label for an important concept.

However, they did generate one as part of a 2005 study, updated in March 2007, by Alan Greenspan and James Kennedy called MEW, for mortgage equity withdrawal. Even before the collapse of the housing bubble and the difficulties encountered by subprime mortgage lenders, the Federal Reserve understood its low interest rate policies of 2001-2004 had inflated the housing market beyond all reason. Their concern was how much the American consumer was using their inflated houses as piggybanks to finance a consumption boom.

One goal of the Greenspan-Kennedy study was to understand just how large MEW was as a percentage of personal disposable income. MEW had to be divided further into gross MEW and net MEW, the amount of money actually available to the borrower after the mortgage service industry took its cut. Net MEW as a percentage of personal disposable income increased from 2.5% in 2000:Q4 to 10.5% in 2004:Q3. Interestingly enough, one benefit of all those low- and no-documentation loans was the mortgage service industry became more efficient at delivering funds to borrowers. Extraction costs, a horrific-sounding concept, fell from 7.0% of mortgage originations in 2000:Q3 to 3.1% in 2003:Q1.

Chart 1: The Cost And Importance Of MEW



The data strongly suggest consumers were reining in the use of MEW as a source of disposable income well before housing prices started to soften in 2006 and subprime lenders started to run into trouble. Net MEW as a percentage of personal disposable income fell from 10.4% in 2005:Q3 to 2.9% in 2007:Q1, the last datum available from national GDP accounts. This is not a low number by historic standards, which suggests a further decline is both likely and probably inevitable.

Now we can approach the question whether a decline in MEW back to historic levels will be a disaster for consumer spending and hence recessionary. The answer appears to be, “No,” when taken by itself. However, any complete answer to this question has requires knowledge of downturns in other sources of personal income or rising claims against that income.

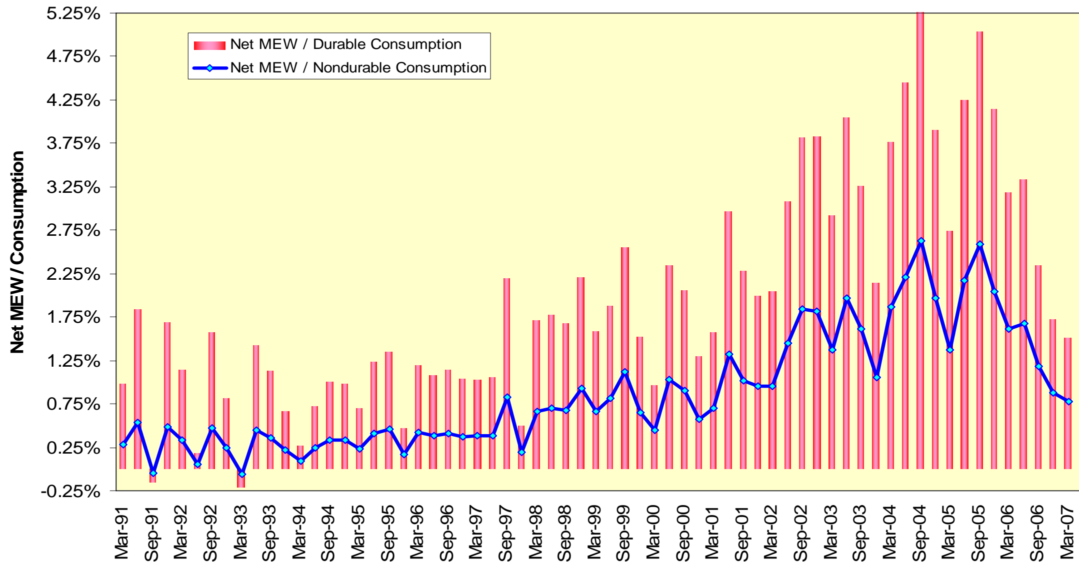
A Consuming Passion

Perhaps as a result of a volunteer armed forces and a smaller fleet, fewer people have a direct and personal connection to the spending habits of drunken sailors. They are alleged to be profligate, so let’s assume they are not out there shopping for what economists would classify as durable goods but rather nondurable goods and services.

Has the allegedly over-leveraged American consumer engaged in similar behavior? Not really: If we compare net MEW to personal consumption for durable and nondurable goods, we can see how much of the increase in MEW went toward durables such as home improvements and other items with capital good-like qualities. Extending the budgeting analogy, while spending on nondurable goods increased along with MEW, we cannot conclude households were meeting their operating budgets by drawing upon their capital assets.

In other words, borrowers are a lot more responsible than portrayed by their demonizers. If you have done a cash-out refinancing or drawn on a home equity line of credit, take a bow. You are in good company.

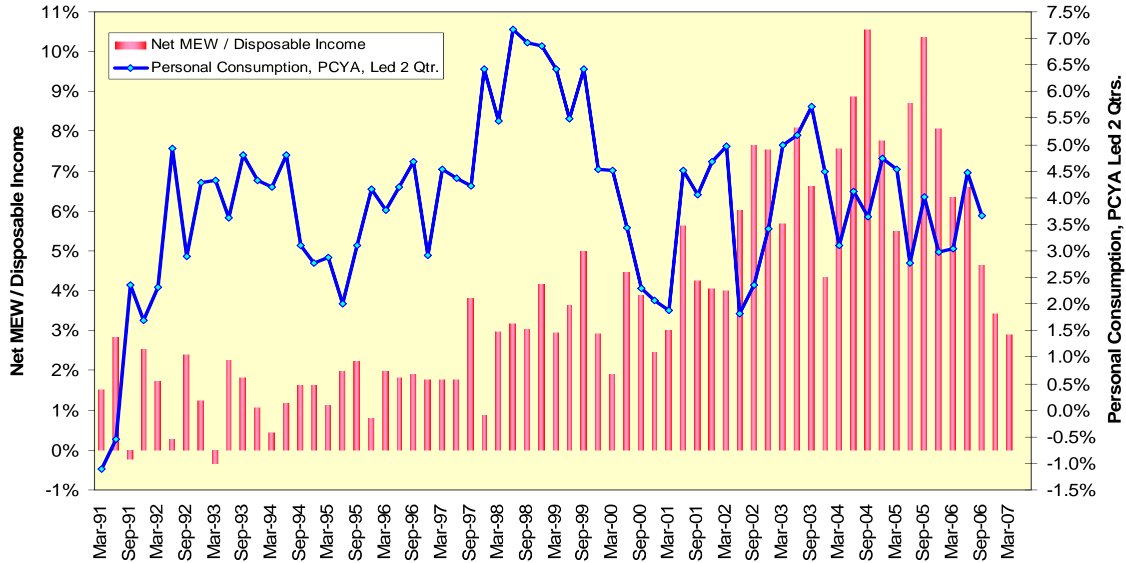
Chart 2: MEW And Personal Consumption



Now let's move beyond the value judgments associated with praising durable goods and scorning nondurable ones and see whether the percentage of disposable income represented by net MEW affects year-over-year changes in total personal consumption led by two quarters.

The most pronounced surge in personal consumption occurred during the late 1990s boom and can be linked more with that period's giddy rise in equity prices more than anything in the home equity extraction market. Reinforcing that supposition is how small an impact the MEW boom of 2003-2005 had on personal consumption. The notion American consumers have been leveraging themselves to the hilt to finance a spending binge simply is not supported in the data. However, the downturn in MEW as a percentage of disposable income in early 2007 does appear likely to exert a negative effect on consumer spending if past relationships hold.

Chart 3: MEW And Changes In Personal Consumption

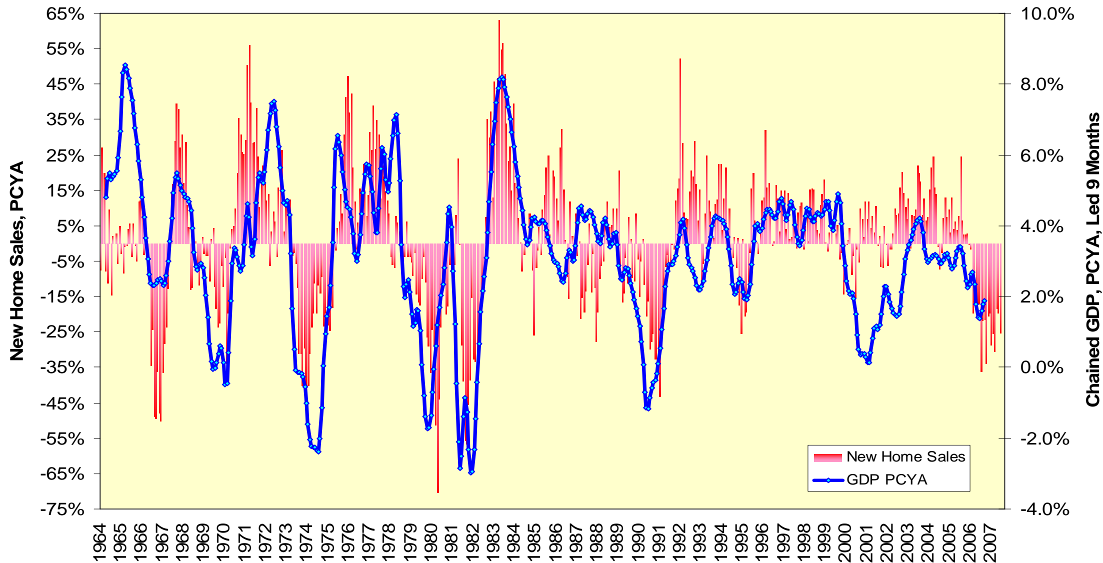


The Housing Connection

There is never a shortage of things over which to worry, and one of the principal concerns has been a decline in new home sales somehow will pull the country into a recession. What has been the long-term connection between new home sales and GDP growth?

The answer, somewhat surprising given the normally erroneous conventional wisdom, has been a fairly close one. New home sales are reported monthly; constant-dollar (chained) GDP data are reported quarterly. We can interpolate the latter down to a monthly time series and measure its year-over-year changes relative to those for new home sales. The changes in new home sales lead those for chained GDP by nine months on average.

Chart 4: New Home Sales And Real GDP



Negative changes in home sales led downturns in GDP in 1966-67, 1970, 1974-75, 1979-82, 1991-92, 1995 and 2000-01. Only one time in the past four decades, 1987-88, did the relationship fail. We can surmise from this the same conditions leading to downturns in new home sales are the same ones pressuring GDP.

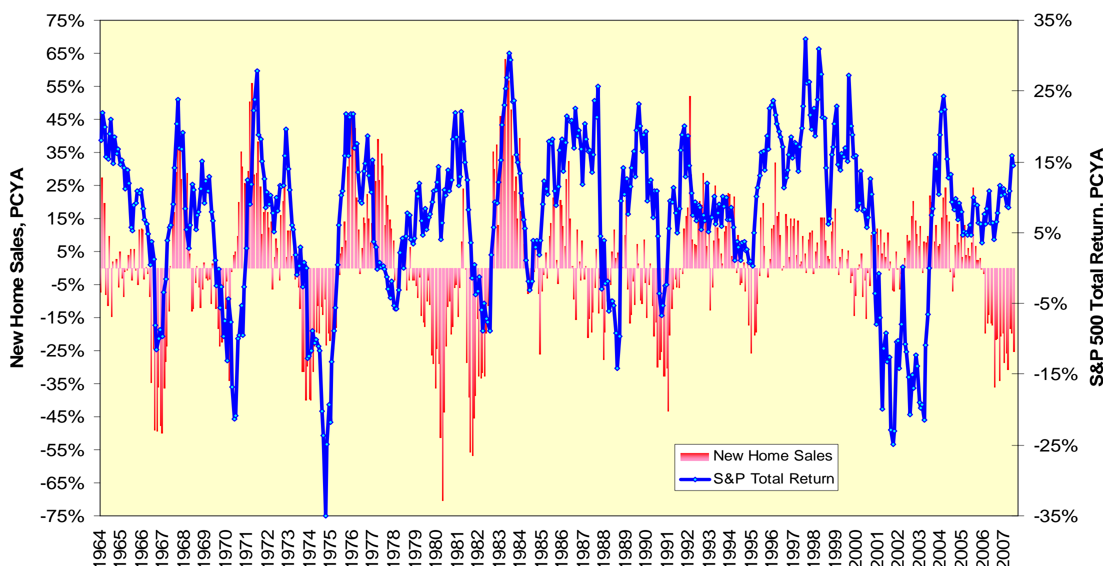
Financial Market Impact

Whatever happens to GDP does not necessarily transfer into financial markets. Neither stocks nor bonds are GDP futures, and too many lose sight of this simple fact. A top-down approach to investing, one beginning with the global economy and then extending down to the U.S. economy and then into economic sectors, industry groups and individual firms is doomed to underperform if not fail outright.

Long-term interest rates have had a generally inverse relationship against year-over-year changes in new home sales, but we should be careful about over-analyzing these data. Too many extraneous factors, such as inflation expectations, the shape of the yield curve and currency volatility affect the absolute level of long-term interest rates to even begin to think about them in terms of a single growth-related factor such as new home sales. It is best to say that when long-term interest rates deviate upward from their ongoing trend, new home sales fall. The opposite holds true as well; when long-term interest rates deviate downward from their ongoing trend, new home sales are stimulated.

What about U.S. stock prices? Here the relationship is inconsistent. The housing boom overlapped the 2001-2002 bear market, the worst since the Great Depression, and a severe housing slowdown in 1979-1981 overlapped some good year-over-year gains in the U.S. stock market.

Chart 5: New Home Sales And The U.S. Stock Market



As we cannot emphasize enough, stocks are not GDP futures. They are priced off expected earnings, expected changes in interest rates and contain a risk multiple designed to equilibrate their returns with respect to other investments. If an acceleration in home sales, which is consistent with stronger economic growth, induces higher long-term interest rates, the results may not be rewarding at all for equity investors.

It is always interesting to see market indicators come into and fall out of fashion. The rise and fall of residential real estate in the U.S. started to take on exaggerated importance in 2005 as people realized home prices had exceeded their long-term sustainable growth path and were far more likely to fall than rise.

But the damage is containable. As the Greenspan-Kennedy study showed, MEW does not drive consumer spending and homeowners as a group did not abuse their homes as sources of spending cash. And new home sales, while by definition important to GDP, are far from its primary driver and have a weak and unstable relationship with stock and bond markets at best. Traders are advised simply to ignore the short-term noise housing reports have been producing.