Paul Taylor's

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ECONOMIC UPDATE

National Automobile Dealers Association, Industry Analysis Division

LOW INTEREST RATES WASTED IN REGULATORY MUDDLE

By Paul Taylor, NADA Chief Economist

The important point is that extremely low current mortgage rates are doing very little for financing and refinancing of homes with homeowner equity or without equity, and thus doing very little for the economy and the related recovery of new car sales.

The next FOMC meeting is in November, a two-day event that will announce policy the day after Election Day for all of House of Representatives, some U.S. Senators and quite of few Governors, state and local officials.

The Federal Open Market Committee is struggling with the idea of taking additional significant action to stimulate economic activity right after the election. The FOMC stated the following in the press release for recent September FOMC meeting:

"Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels for the federal funds rate for an extended period."

Rates are very low for Treasury bills at the short end of the yield-to-maturity relationship. What Chairman Bernanke might wish to do is try to target rates at 10 years and above, which could keep long-term borrowing rates low for the Government. This possible policy has been labeled the "Bernanke Put" because it would be accomplished by the Fed purchase of long treasury notes any time the actual yield approached and threatened to exceed the desired rate, say 3 percent as an example close to reality for the current 10-year Treasury Note. This would help the Treasury borrow money at lower rates. Since mortgage instruments are priced off the U.S. Treasury 10-year Note, it would make for continuing low fixed-rate home mortgage rates.

There are two big "ifs" in this policy.

First, the policy works if the public continues to believe that inflation will remain "subdued" in the near future, as noted in the FOMC statement quoted above.
In the past, efforts to "twist" down the long maturity end of the yield to maturity relationship caused lender to anticipate inflation, and thus the policy failed to work for any reasonable amount of time.

Second, the policy works if the "monetary transmission mechanism" of an interest rate driven monetary policy is working efficiently. In this case, the transmission mechanism is Banks, Thrifts, Credit Unions and Finance Companies making business loans and mortgage loans at low rates related to the very low Treasury yields. Currently, that mechanism has been slowed by the dramatically higher amount of documents required to buy a home or even refinance one. The reason for an ineffectual slow loan mechanism? The bank examiners (bank regulators' boots on the ground) have scared the financial institutions into a very slow and cumbersome loan process, even for borrowers with nearly perfect credit histories.

The theory is that we have a current policy option to refinance real estate that could free up household cashflow by an aggregate amount more than the recently extended unemployment benefits will provide. The money would go to mostly-employed homeowners who are reasonable prospects to buy a new car or truck, but much of the lending and refinancing is very slow or simply not getting done. The typical delay to refinance can be up to two months or more in process. This is a key reason that economic recovery is painfully slow. Many homeowners who would benefit simply throw up their hands and continue to pay their current higher rate.

Glen Hubbard of the Columbia University Business School points out that since the bailout, the Federal Government explicitly guarantees the loans from Government Sponsored Enterprises (GSE's) Fannie Mae and Freddie Mac. There is little additional risk and cost to taxpayers to refinancing all of the loans that have home values lower than the current Freddie or Fannie loan amounts. The taxpayer is already on the hook, and this action could keep most of the current owners in their houses. That suggested policy would transfer some wealth to homeowners and take away the excess returns that mortgage investors received because of the bailout of Freddie Mac and Fannie Mae.

Public dollars protect the GSE mortgages either way. No changes prior to the mid-term elections are likely on this issue. With refinancing of the GSE-financed homes, however, the outlook for state tax revenues and overall real estate values would increase as additional houses are kept out of the market. With home prices falling just a few percent per year in most states currently, this would be the proper timing to put in a bottom on falling home prices.

Refinancing positive equity homeowners, by contrast, is not controversial. In many cases, the homeowner is bringing money to the table to bring the house to a twenty percent equity situation and avoid private mortgage insurance.

The important point is that extremely low current mortgage rates are doing very little for financing and refinancing of homes with homeowner equity or without equity, and thus doing very little for the economy and the related recovery of new car sales. Additionally, car dealers and other small businesses are having a hard time getting loans on commercial real estate that they own. The advantages of the low interest rate policy are being squandered, as the boots-on-the-ground bank examiners thwart the announced policy of the Federal credit regulatory apparatus. Some foregone U.S. car sales in late 2010 and in 2011 are part of the collateral damage of this missed opportunity.

WHILE THE UNITED STATES STRUGGLES, EUROPE AND ASIA ARE GROWING MORE RAPIDLY THAN WE EXPECTED. RECORD WORLD CAR SALES COULD RESULT WITHOUT STRONG U.S. SALES

Despite the recent recession felt around the world, Europe is recovering more quickly than anticipated two months ago from a real estate bubble similar to our own. Asia, inclusive of China and India, is growing more swiftly as world demand increases for both resources and finished goods.

Some pundits suggest a new record level of world light vehicle sales, despite the slow economic growth and modest volume increase in car sales in the United States, while a naysayer or two would suggest there are steeper financial challenges ahead for Europe. The United States has much less progress than Europe on respective real estate bubbles, even as the Europeans never admitted their real estate problems. The one relatively large nation in the EC avoiding the creation of a real estate bubble was Germany, which leaves the banks there ready to assist world sales of German-produced cars and trucks. So export led growth of cars from European makers is one key bright spot looking toward 2011 and beyond. World light vehicle sales are currently 16.1 percent ahead of last year.

Looking to the major economic engines in Asia, China and India, sales of cars and trucks are accelerating. There is some good news for the United States and Europe in China sales growth. In compact car sales, the largest sales categories, year-to-date sales show the Buick Excelle in fifth place, and the Volkswagen Lavida and Jetta in second and third respectively. In first place? The BYD (Build Your Dreams) F3, from the company in which Warren Buffet has placed a large investment. In Sub-compact cars the Nissan Vivina is fourth in sales, the Volkswagen Polo is third and the Honda City first.

The Polo, smaller than the Honda Rabbit seen in the U.S., is the same China-produced Polo that has been shipped to the Australian market for more than five years. Will Volkswagen dare ship Polo's into Germany from China? Time will tell. In the smallest offerings, minicars, a Suzuki model is fourth and the Chevrolet Spark third, behind homegrown offerings the BYD FO and the Chery QQ. Can it be much longer before we see smaller cars coming to the U.S. from China?

For midsized cars, the top five models are Accord, Camry, a Nissan model, the Volkswagen Passat and the Buick LaCrosse. The communists for decades have thought highly of the big sedans of the "Capitalist Roaders." In luxury cars, the Audi A6 and A4 are first and second, followed by the BMW 5-series, the Mercedes E class and the Lexus ES. China goes for smaller CUVs, with the Honda CR-V in first place and the Great Wall Hover H ahead of Toyota RAV4 and Toyota Highlander. Among Minivans, the Buick GL8 is second in sales, while the Honda Odyssey is fourth, ahead of the FAW (First Auto Works) Xenia M80.

In India, Mahindra and Mahindra diesel compact trucks and SUVs are finally getting ready to ship to dealers in the U.S. who have been waiting for as long as six years. Better late than never, and the timing should be good in a U.S. market coming out of recession. Business buyers are still looking for a bargain and lower operating costs on truck purchases. Used truck and SUV prices have increased the most among a strong overall rise in used vehicle prices.

In the Indian home market, light-vehicle sales increased by 34.3 percent in August to 204,227 units while exports to the rest of the world declined 7.4 percent to 38,279. Weaker European markets were a key element in the export slowdown. Maruti/Suzuki is number one in car sales, followed by Hyundai and Tata Motors. In light truck sales, Tata has a slight lead over Mahindra and Mahindra with sales of 230,622 units in 2009. Maruti/Suzuki sold at half the rate of each of the first two and Toyota, a distant fourth place, with 45,411 light trucks sold in 2009. GM and Ford sold 14,527 and 2,099 light trucks in India during 2009. For the U.S. the light truck unit count was over 1 million each for GM and Ford.

ALL VEHICLE SALES ARE LOCAL, AS THE LATE SPEAKER TIP O'NEIL MIGHT HAVE SAID, AND ALL POLITICS ARE AS WELL

We are entering the last month of an intense national debate on our economy as Americans head to the polls to vote in Congressional, state and local elections.

NADA Industry Analysis models better economic growth as depending upon improvement in home prices for homeowners, and improving employment prospects. In predicting new light vehicle sales changes, home prices are more important because nearly all homeowners have lost some home equity in recent years, while 90 percent of the workforce remains employed.

Consumers unemployed for more than 20 weeks will not be in the new car market for a couple of years, while those remaining employed over the last 5 years could buy a new car tomorrow. When will they? Homeowners will feel inclined to consider a new car purchase when their nest egg of home equity is secure. What is happening in your city or town? The attached map of regions in the United States shows trends for your region. For your local sales areas, look up the House Price Index by state, city or standard statistical area at www.fhfa.gov and click on House Price Index.

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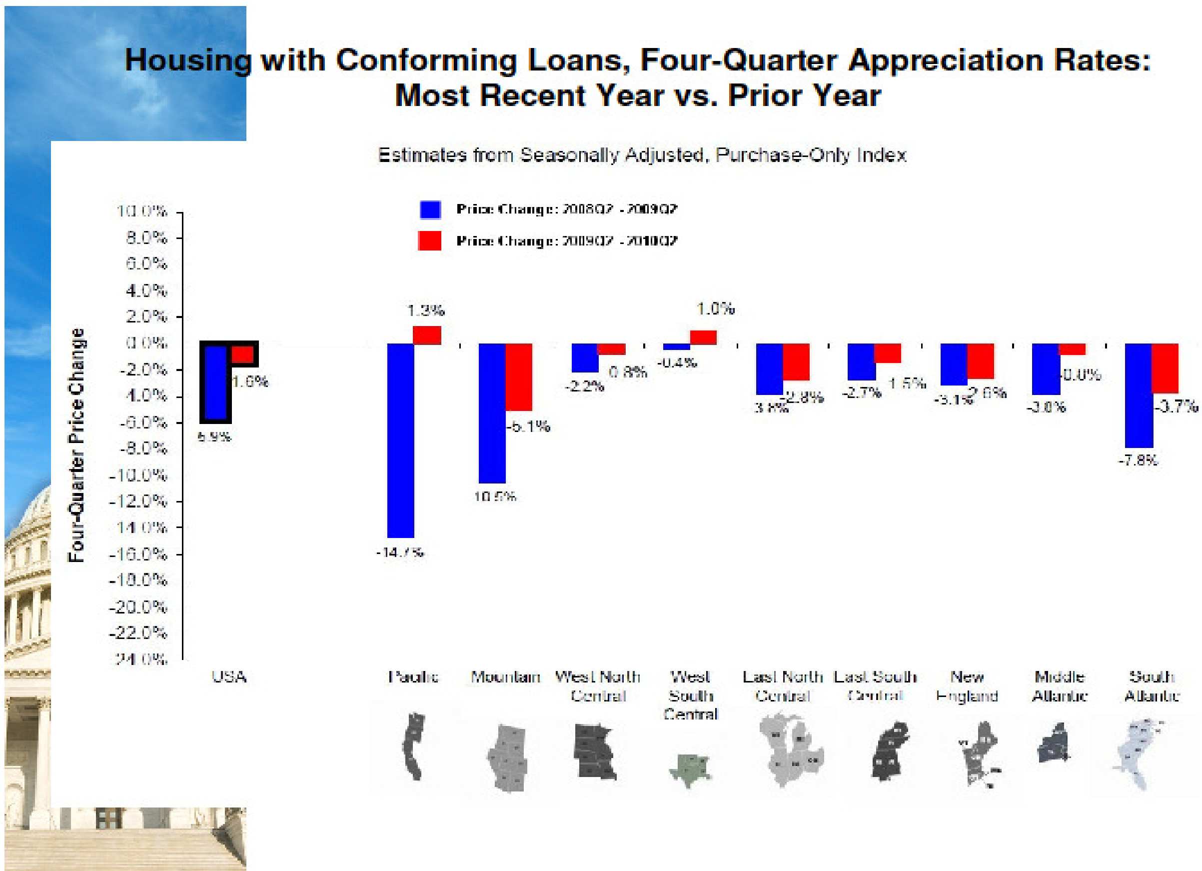
Housing with Conforming Loans, Four-Quarter Appreciation Rates:
Most Recent Year vs. Prior Year
Estimates from Seasonally Adjusted, Purchase-Only Index
Price Change: 2008Q2 - 2009Q2
Price Change: 2009Q2 - 2010Q2
Four-Quarter Price Change
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
-10.0%
-12.0%
-14.0%
-16.0%
-18.0%
-20.0%
-22.0%
-24.0%
1.3%
1.0%
-1.6%
-5.9%
-14.7%
-10.5%
-5.1%
-2.2%
-0.8%
-0.4%
-3.8%
-2.8%
-2.7%
-1.5%
-3.1%
-2.6%
-3.8%
-0.8%
-7.8%
-3.7%
USA
Pacific
Mountain
West North Central
West South Central
East North Central
East South Central
New England
Middle Atlantic
South Atlantic