Webster® EconomicReview

Musings & Amusings

"The EU should expand and bring peace to the world's more troubled region. Perhaps the set of 'Two and a Half Men.'" –Craig Ferguson

"President Obama met with leaders of the American Indian tribes and they honored the president by giving him his own Indian name: 'Running Deficit.'" –Jay Leno

"McDonald's reported today that it had better than expected sales. Executives credit the success to increased advertising, new menu items, and two states legalizing weed." –Jimmy Fallon

with Nicholas S. Perna, Ph.D., Webster Bank Economic Advisor

Chubby is better! I came back from a great holiday visit with my grandchildren to a pile of depressing newspapers. A "deal" was reached only temporarily avoiding the fiscal cliff. Legislation providing aid to the many victims of Sandy in our region was postponed. However, there was also an article claiming that mortality rates actually fall as weight rises. Music to my tummy! Bring on the carbs! Maybe we'll find that bigger deficits are actually good for the economy...

After expelling much hot air (the real reason for global warming) the folks in Washington extended the Bush-era tax cuts for all but those joint filers reporting more than $450,000 per year. These and other tax changes were made permanent, i.e., no expiration dates. Emergency unemployment benefits were continued for another year, but the "payroll tax holiday" was not, shrinking take-home pay by 2 percent for many workers.

The "deal" failed to address some huge issues. The nearly $110 billion in spending cuts that were supposed to start January 1 were postponed for two months. Also, the debt ceiling was not increased so that we might still hit a "fiscal wall" sometime in March, when the Treasury runs out of borrowing power. And if that's not enough, the temporary funding measure that is keeping the government running expires on March 27. So the "deal" has done little to lift the uncertainty that is hobbling the economy, giving a whole new meaning to March Madness!

Making the tax changes permanent essentially takes taxes off the table in the deficit reduction deliberations – at least in the opinion of Republicans – thereby shifting the focus almost entirely to spending, especially entitlements. Late last year, there was some talk that Speaker Boehner and President Obama were contemplating replacing the Consumer Price Index (CPI) with the Chained CPI in calculating cost-of-living adjustments for Social Security and certain other items. This is worth a closer look.

The spending weights in the familiar CPI are updated only every two years. Hence, it tends to overstate inflation by understating the shift away from items whose prices are rising more rapidly, the so-called "substitution effect" from Economics 101. The Chained CPI adjusts the weights monthly, recognizing that people switch their spending from, e.g. hamburgers to hot dogs if ground beef prices rise faster.

The government uses the CPI to calculate annual increases for Social Security and Veterans' benefits. It is also used to adjust federal income tax schedules to keep inflation from pushing taxpayers into higher brackets.

Over periods of several years, the Chained CPI has tended to rise 0.2 percentage points less annually than the official CPI. These small differences can add up to big savings... paring roughly $200 billion from the federal budget deficit over the coming decade.

Treasury Inflation Protected Securities (TIPS) provide full protection from increases in the CPI. My guess is that existing TIPS will continue to use the conventional CPI but newly issued TIPS would use the chained version if the switch is made for entitlements.

"the 'market value' of your bond holdings can drop if interest rates rise."

Another bubble? Remember the Y2K non-event? Since then we've had the dot com bubble, the housing bubble and the stock market bubble. Now, there's even talk of a bond bubble (and that's not the next 007 flick).

Stated simply, the "market value" of your bond holdings can drop if interest rates rise. I remember getting a call from my brother some years ago. He had just gotten a 401K statement showing his bonds had gone down since the last report. He had moved out of stocks to avoid this and couldn't figure out what was going on. I tried to explain and even over the phone could just *feel* his eyes glazing over!

Let me try again. Suppose you recently paid $100 for a brand new 10-year U.S. Treasury note (bond) that will pay you a whopping 1.5 percent interest per year. If you hold it to maturity, you'll get that $100 (face value) back in full.

But what if prevailing interest rises to, say, three percent immediately after your purchase? You'll continue to get your 1.5 percent every year, so that's not a problem. And if you hold on for 10 years, you'll get your $100 back.

The difficulty arises if you try to sell now. Nobody is going to pay $100 for your 1.5 percent bond when they can get a new one yielding 3 percent from the Treasury. The only way you can sell yours is by marking the price down closer to $87 so the buyer of your bond can earn the market rate of 3 percent.

If rates stay at 3 percent, the bond's "market value" will gradually rise to the face value over the next 10 years. If rates fall, the price will rise faster. If interest rates climb higher, the bond price will drop even more. If that overnight jump was to 6 percent, the bond's market value would drop to around $67 and then start climbing gradually.

So is there a bubble? Yes and no. According to the latest survey of economists by the *Wall Street Journal*, the 10-year Treasury is expected to yield 2.3 percent by the end of 2013 and 3 percent a year later. Hence, bond market values are likely to decline.

How might rising rates affect you? Not much at all if you bought your bonds for the income with plans to hold to maturity. However, if you need to get at the principal before maturity, then you could have a problem because you'll have to pull out less than you paid.

The sensitivity to interest rate changes (aka "duration") is higher for longer maturity bonds and lower for higher coupon bonds. Accordingly, the greatest sensitivity of market prices is for long maturity zero coupon bonds whose accumulated interest is paid at maturity.

Finally, there are huge differences between a potential "bond bubble" and something like the dot com fiasco. Many of those investors lost everything: there were no dividends and the shares became worthless as the firms vanished. Unless you've been buying some really risky bonds, this is very unlikely to happen.

House prices: bad news… good news. I just received the new assessment of my house from the town and it is down about 20 percent from 5 years ago. Of course, my taxes won't drop because the mill rate will have to rise for revenues to keep up with spending. However, prices are stabilizing and have begun rising in much of the country. The extent varies considerably across regions and prices still have a long way to go practically everywhere.

One good source of price information is the Federal Housing Finance Agency (FHFA) which collects data from Fannie Mae and Freddie Mac, the big purchasers and packagers of home mortgages. These prices are for homes financed by "conforming" mortgages that meet certain stipulations about down payments, credit worthiness of the borrower, etc. Because it covers "high quality" mortgages, FHFA data doesn't show as big a decline as some other indexes which include foreclosures.

House Prices: 3rd Quarter 2012

	Percent Change		
	1-year	5-year	since 1991
Connecticut	0.1	-15.3	67.2
Massachusetts	0.7	-8.9	117.4
Rhode Island	-1.6	-21.5	77.0
New York	-0.4	-7.5	103.9
United States	4.0	-15.4	87.9
Arizona	20.0	-36.7	93.5
Florida	7.9	-35.9	84.6
New Jersey	-1.1	-17.8	109.8
New Hampshire	-1.5	-17.4	89.9

Nationally, the news is good. Prices have started to rise, but are still below the levels of 5 years ago. The U.S peak was in 2007 so that the second column gives an indication of how far below that the nation and each state are. In only a few parts of the country are prices at or above 2007 levels: the District of Columbia, Alaska, North Dakota, South Dakota and Texas.

Connecticut has been essentially flat the past year and looks almost exactly like the nation relative to 2007. Massachusetts and New York haven't been rising recently but they didn't fall nearly as much as the rest of the country.

Although Arizona and Florida are near the top of recent gains, they are still well below 2007 levels. New Jersey and New Hampshire are near the bottom of 1-year growth and have a bit farther to climb than their immediate neighbors.

So I guess the good news is that housing is more affordable. The bad news is that it's my house...

Economic Review is published by Webster Financial Corporation. The opinions and views in this publication are those of Dr. Nicholas Perna, Webster's economic advisor, and are not intended to provide specific advice or recommendations for any individual. Consult professional advisors with regard to your individual situation. For more information or to submit a story idea to *Economic Review,* contact Bob Guenther by telephone at 203-578-2391 or by email at rguenther@websterbank.com. © 2013 Webster Financial Corporation.

The Webster Symbol and Webster are registered in the U.S. Patent and Trademark Office.
FN01144 01/13

EQUAL HOUSING LENDER
Webster Bank, N.A.
Member FDIC

Webster®