

# HOUSING BOND REPORT

A MONTHLY PUBLICATION ON THE LOW-INCOME HOUSING TAX-EXEMPT BOND INDUSTRY

July 2004, Volume VII, Issue VII, Published By Novogradac & Company LLP

## Multifamily Housing Revenue Bonds: Market Snapshot

By Lauren Deneka, D.A. Davidson & Co.

The first half of 2004 was a wild ride for housing revenue bond market participants. While the year began with historically low borrowing rates hovering near and under 5 percent, bond yields rose dramatically in April to upwards of 5.50 percent and then reverted back to the 5.30 percent level in May on the combined forces of economic data indicating the economy is cycling upward, rising terrorist fears and predictions of federal funds rate tightening. At the beginning of June, the 30-year housing revenue bond yields were approximately 5.40 percent and the 10-year bond yields 4.70 percent.

Yields on bonds are trending steeply upward on the continued release of positive economic data, including:

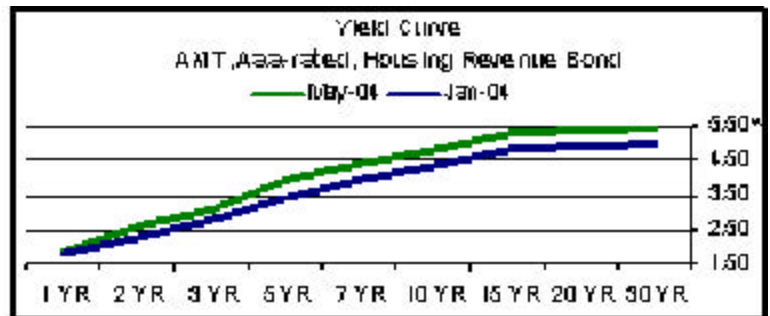
- ♦ Marking the tenth consecutive month of economic expansion and the eighth of record Gross Domestic Product (GDP) readings, first quarter GDP was 4.4 percent, driven by an increase in business inventories, gross private investment, residential construction and personal consumption expenditures;

- ♦ The Consumer Price Index (CPI) rose to 1.8 percent in the 12 months through April;

- ♦ Industrial production rose 0.8 percent;

- ♦ Unemployment fell to 5.6 percent;

- ♦ Average hourly earnings rose 0.3 percent and are now up 2.2 percent year-over-year.



Simultaneously, bond yields are experiencing a slight, but noticeable, downward pressure by the continued supply of bond investors who seek the quality and safety of bond securities. Despite the positive economic indicators, investors continue to question the future of the economy, taking into consideration the unsustainably high consumer spending levels and persistent terrorist threats. Investors are monitoring the increase in fixed-rate mortgages and the dip in refinancings, which are now 83 percent below the all-time high in May of 2003. Refinancing was a major source of cash for the consumer; with wage growth weak and consumer debt high, it is questionable how the economy will absorb the inevitable slowdown in consumer spending.

But, overriding the economic data and terrorist woes, the bond market is pricing into current yields the changing borrowing environment of the tightening of the federal funds rate. While all verbal clues from the Federal Reserve indicate the tightening will be measured and progressive, the market has priced a 75 basis point immediate tightening into today's yields, boosting housing revenue bond borrowing rates to at least 5.30 percent.

Interestingly, the Federal Reserve has been uncharacteristically articulate about its policy goals and accom-

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panying analysis. The Federal Reserve believes that while rising prices have offset any threat of deflation, price increases will be limited as long as businesses, for fear of the loss of customers, do not pass along the rising costs of energy and labor. "As I have noted previously, the federal funds rate must rise *at some point* to prevent pressures on pure inflation from eventually emerging," Federal Reserve Chairman Alan Greenspan said. "As yet, the protracted period of monetary accommodation has not fostered an environment in which broad based inflation pressures appear to be building."

Furthermore, the Fed removed the "patient" language from its policy statement and replaced it with "measured," implying an increase is imminent but not defined. This change is particularly applicable considering job gains are an important variable for the Fed and, even though payroll growth is strong and unemployment is decreasing, the economy needs to create an additional 800,000 jobs to reinstate the jobs lost during the recession. Combine this with the data indicating inflationary pressures have not yet made their way to the final buyer and you have a great case for a slow and measured tightening happening over a prolonged period in 2004 and 2005.

Applying these policy statements, the bond market is reacting in its historically appropriate manner: the yields on bonds adjust upward prior to any tightening in the fed funds rate by the Federal Reserve and any mention of inflation causes stock and bond traders to launch heavy sell programs. While increasing borrowing rates is a self-correcting mechanism to bring long-term borrowing in line with the emerging economic cycle, it also, perhaps, heads off an immediate drastic change in Fed policy. The chart below identifies the historical change in 30-year Treasury rates during and after changes on the overnight fed funds rate (identified by the rising arrows).



What is most evident in the graph is interest rates on Treasury bonds have been at their lowest point in 50 years. Housing developers who

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ISSN 1536-6847

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closed deals in the first quarter of 2004 reaped the benefit of these low borrowing rates but, with an expanding economy, these borrowing rates were simply untenable. The trailing five-year average housing revenue bond yield is 5.50 percent; the housing bond market may be returning to yields in that range sooner than anyone would have predicted, based on the whether there is constant growth of the economy and the pace of increases to the fed funds rate. Key indices to watch are employment (increased pay-rolls), sales and production (rise in retail sales and boost in business inventories), and inflation rates (increase in CPI). ♦

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