business will pass these costs through the system causing inflation. Being essentially a monetarist, I lean toward the former in that higher crude prices reduces the domestic real supply of money if we assume a constant Fed policy.

Second, earnings have been very robust for the past few years and although next year's growth may not match the recent record, corporate earning may still grow by nearly 10 percent. Corporate earnings growth will be hampered by the strong dollar and a consumer sector that is already spending at the "max". On the upside is a rate of productivity growth that does not show any signs of slowing. But the net is that earnings will grow but at a slower rate than in the recent past.

Third, will this slower growth upset investors? This is where risk premiums enter our discussion. Until this past spring we had seen risk premiums decline to the lowest level in memory. It is always difficult to separate the effects of declining risk premiums from rising expectations but it appears that over the past few years that expectations were rising and risk premiums were falling.

Since last spring the NASDAQ index has fallen sharply relative to both the Standard and Poor's 500 and the Dow Jones Industrial Average. This indicates that there has been an increase in the risk premium. It should be noted that this increase appears to have just restored the risk premium that evaporated during the speculative surge in the five months, November 1999 through March 2000. Therefore, there may be further relative erosion of the prices of the riskier part of the stock market.

There are imponderables that will worry the financial markets. The two big ones are full-fledged warfare in the Middle East with its impact on oil supply and prices and the future of the Euro. Barring any major calamities we look for a 50 to 70 basis point decline in short rates and steady long rates. The stock market will be the driven more by the nexus of risk premiums and expectations than by actual interest rates and earnings realizations. There is a real probability that the riskier part of the stock market will under perform the more defensive part of the market. Remember that valuations are still relatively high. So short term investors: "you be careful out there". But long term investors (7 years and longer): "hang on Sloopy hang on".

Soft Landing for Housing

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Housing starts have been slowing throughout the year 2000. During the first quarter of the year housing starts were at a 1.7 million unit pace but by the third quarter the pace had slowed to about 1.5 million units. The average for 2000 will likely come in at around 1.6 million housing starts but for 2001 the rate is likely to be about 1.5 million starts. This is not a drastic decline but suggests a "soft landing" for housing as the impact of higher interest rates and perhaps lower equity prices has had an effect on housing markets. New and existing home sales are also likely to come in at a lower level for the year 2000 than the previous year and continue to decline in 2001.

At the same time, the "good news" is that the percent of Americans who own their homes hit a record high 67.7 percent in the third quarter of 2000 according to the U.S. Department of Housing and Urban Development. The relatively low mortgage rate environment and steady home prices has no doubt contributed to the ability of more people to purchase a home. In fact, the national median home price for both new and existing homes actually declined in 1999 to $133,000 from $147,000 the previous year. The deductibility of mortgage interest for the purposes of calculating federal income taxes no doubt also continues to encourage home ownership. The IRS recently reported that nearly 31.5 million federal income-tax returns for 1998 included a deduction for home-mortgage interest payments. This represents about one fourth of all tax returns and a lot of voters who are unlikely to support elimination of the home mortgage interest deduction (even though Morton Marcus has stated during past Outlook Panels that this just subsidizes rich people)!

Lower home prices in 1999 resulted in an increase in the housing affordability index to 137.8. An index of 100 indicates that the median income family can just afford to purchase the median price home at current mortgage interest rates. A rate over 100 indicates greater affordability. Housing affordability is likely to remain relatively high through 2001 because neither home prices nor interest rates are expected to increase much during the next year. The median home price likely ended the year 2000 up slightly from last year but remained below the record level reached in 1998.

Mortgage interest rates are likely to stay at about the current level, depending of course on the effect Fed policy has on interest rates in general. Mortgage rates are likely to stay below 8 percent over the next year keeping them at a relatively attractive historical level. The gap between fixed and adjustable rates has been narrowing as short-term interest rates have increased relative to longer tem interest rates.

The exhibit below from the National Association of Home Builders website summarizes recent trends in housing and interest rates as well as their forecast for the year 2000 and 2001.

Housing and Interest Rate Forecast**

	1998	1999	2000	2001	2002
Total Starts (000)	1,622	1,675	1,602	1,508	1,522
Single Family (000)	1,278	1,340	1,262	1,198	1,230
Multifamily (000)	344	335	340	310	322
New Home Sales	890	909	860	808	808
Existing Home Sales (000)	4,962	5,197	4,593	4,309	4,309
Interest Rates (Freddie Mac Commitment)					
Fixed Rate	7.0%	7.4%	8.1%	8.0%	7.8%
ARMs	5.6%	6.0%	7.1%	7.2%	7.1%
Prime Rate	8.4%	8.0%	9.2%	9.5%	9.3%

**Annual data are averages of seasonally adjusted quarterly data and may not match annual data published elsewhere.

Source: NAHB Economics Department