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The Sound Investor Series #51

New Housing Price Derivatives Suggest More Weakness Ahead

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May 31, 2006

Housing prices in the U.S. have increased 12 percent in the year ending March 31. The year before saw prices go up over 18 percent. How much do you think home prices will increase, or decrease over the next year?

Until last week, this would have been an interesting, but mostly academic question. However, the Chicago Mercantile Exchange has just introduced futures and options on futures in the hope of developing an active market in financial products based on real estate prices.

If these new derivatives are successful, investors, speculators and hedgers will have a market to express their opinions. In addition, the rest of us will have information on what the market is thinking.

So what are these new products? They are futures contracts based on the S&P/Case-Shiller Metro Area Home Price Indices. There are individual futures contracts for 10 metropolitan areas and also a future on a value-weighted composite index of these 10 cities. The metropolitan areas are Boston, Chicago, Denver, Las Vegas, Los Angeles, Miami, New York, San Diego, San Francisco and Washington, D.C. In the weighted composite index, New York has the largest weighting (27 percent) and together with LA (21 percent) they make up almost half of it.

The S&P/Case-Shiller Indices (CSI) measure price changes of single-family residential properties. As you can imagine, measuring changes in housing prices is not easy and the CSI indices use a technique they developed called repeat-sales. Essentially, each new sale is matched with the previous sale of the exact same property to create a sales-pair. These sales-pairs form the raw data for measuring overall price changes. The reported index values are rolling 3-month averages and released on a monthly basis.

The promoters of these derivative products hope that large institutions, like insurance companies, will use them to create products for individuals. Someday it may be possible to buy “home price” insurance to protect yourself from falling property values. We will have to wait to see how these new products develop; or are worth the cost.

In the meantime, home price increases are slowing down. The most recent CSI data, for the first quarter of 2006, shows the NY metro area prices increasing 10.6 percent price versus a year ago. This is down from a 15 percent increase the previous year. Digging deeper into the numbers unfortunately, suggests more weakness ahead. On an annualized basis, NY metro area prices are up: 7.7 percent in the past six months; unchanged over the previous 3 months; and down 4.8 percent from the prior month's data. These results are even more discouraging given a seasonal pattern where prices tend to increase in the spring, especially in Northern cities like New York.

The composite data of all 10 cities is weak as well and shows the same trend. On an annualized basis prices are up 12.1 percent (12 mos.), 6.1 percent (6 mos.), 2.6 percent (3 mos.) and 0.9 percent (1 mo.).

What does the market expect in the future? It did not like the new data and fell yesterday. For the next year the market is now expecting prices to increase about 3 percent in both the 10-city composite index and NY metro area. The market gives the best prospects to San Francisco (+5 percent) and worst to San Diego (-1 percent).

Before you decide to run out and buy or sell these products, here are a few cautionary thoughts. Volume is still very light so interpret the price information with a hefty grain of salt.

Second, and more importantly, the difference between the bid and offer prices is very wide. In the typical catch-22 for new products, bid/offer spreads will tighten if volume increases; and volume will increase if spreads tighten.

Lastly, remember futures contracts can be risky as investors are leveraged many times over. When an investor buys a futures contract, they do not pay the other party anything - that is why they are called futures. However, they are required to deposit a small amount of money as margin with their broker, which in the case of housing futures is about 3 percent. This means your investment is 33 times larger than the amount of money you deposit and if the market moves against your position, your deposit can be wiped out very quickly. And you will be faced with additional margin calls in a matter of minutes. Use care!

If you have any questions of comments please contact me at the number and/or website below.

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