



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

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Real Estate: A Buyer's Market

Ed Hynes, CFA

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Yesterday the President of The National Association of Realtors (NAR) declared that we have a "Buyer's Market" with housing in plentiful supply across the country. Certainly this is good news for first time buyers, but not a very appealing state of affairs for current homeowners or those dependent on the housing industry for their livelihood.

A housing slowdown was bound to occur after the past few years' boom, but that doesn't make it any more enjoyable. Everyone knows hangovers are no fun, no matter how good the party the night before.

NAR reported that, on a seasonally adjusted basis, June sales of existing home fell 1.3 percent from May and was 8.9 percent below June of 2006. They also reported that the median price paid for a home was only 0.9 percent higher than last year.

The most discouraging aspect to the NAR report was the number of homes currently on the market. The inventory of unsold homes was up 39 percent from last year and equals 6.8 months of supply at the current sales rate. This is the highest inventory/sales ratio since July of 1997 and is a major concern.

All of us, even if we have no plans to buy or sell in the near future, are affected by what happens in the housing market. For most homeowners, their homes are their biggest asset and if its value falls, so does their wealth and confidence. Falling values also limit homeowners' ability to extract cash with a home equity loan.

Housing construction is a hefty part of the economy. Not only are construction workers directly impacted, but manufacturers of materials and appliances are affected by the level of building activity and home sales. The National Association of Home Builders estimates that the "whole" housing industry represents about 17 percent of our Gross Domestic Product (GDP).

The health of our economy in turn impacts the stock market. Short-term traders might be able to profit from the market's gyrations if it falls, but for most of us, who are investing for our retirement, a strong stock market in the long-term is critical for meeting our goals.

Inflation measurements, interestingly, are often perversely pushed higher by weak housing markets. When buyers are hesitant to commit to purchases, they rent, and this

tends to push up rental costs. These increased rental costs are then incorporated into government statistics such as the Consumer Price Index (CPI). Currently, “owner’s equivalent rental” costs make up around 40 percent of the CPI.

While some may argue this is unfair, this dynamic is just a payback for the past few years lower inflation readings. Everyone knows housing has become more and more expensive, but this was never reflected in the inflation numbers. Changes in the value of assets, such as stocks or houses, are not included in traditional inflation statistics.

Where will housing prices go from here? One place to look for guidance is the new Housing Derivatives futures market at the Chicago Mercantile Exchange. There are individual futures contracts on 10 major metropolitan areas as well as on a weighted 10-city Composite Index. These products, which are based on the S&P/Case-Shiller Home Price Indices, have been trading for only a couple of months and volume is light, but nevertheless, they give us an indication of where some investors think prices are heading.

After yesterday’s release of the NAR and new S&P data the August housing futures rallied as prices are holding up better than expected. However, the futures which expire next May were mixed to slightly lower. This was probably a reaction to the higher inventory levels, which may put pressure on prices.

The market now expects the 10-city Composite Index to fall 2.8 percent from February to the end of February 2007. All the individual cities are bunched in a tight range around this level with expected declines ranging from 1.8 percent (Denver) to 5.5 percent (San Francisco).

The futures market appears to be very negative as year-over-year price declines in single-family homes are unusual. In the last 20 years, the composite price index only dropped in excess of 2 percent during the recession of 1990-91 when it was down 6.3 percent. On the other hand, we have just come off a huge 5-year housing explosion, fueled by super-low interest rates and variable-rate mortgages. In addition, the home building companies are saying the seasonally strong spring selling season was very disappointing.

In summary, the housing market is a critical component of our economy and signs point to continued weakness. How weak will largely depend on the Federal Reserves and how high it raises rates to fight inflation. For homeowners needing to sell today, the best advice I have heard is to price it to move. Trying to get an extra 10% over value today may mean settling for 20% less in 12 months. As the man said - “It’s a buyer’s market.”

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. Farm Creek is a registered broker/dealer and Investment Adviser. This series of articles is available at farmcreeksecurities.com.

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