



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

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Will Weak Housing Bring Down the Economy?

Ed Hynes, CFA
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Where's the economy headed now? It looks like that while the housing market continues to struggle the overall economy is doing pretty well and will continue to do so.

Earlier this week, Sandra Pianalto, the President of the Cleveland Federal Reserve Bank said she expects "the economy to weather the recent challenges in the housing market" and "to grow at a moderate, but sustainable pace." This seems to be the consensus view and while I'm often a contrarian, I do not see any strong evidence to support fears that the weak housing market will cause a recession.

Last week's employment report supported this view with the unemployment rate dropping to 4.4 percent. Although payroll employment numbers look a little weak on the surface - with a gain of 92,000 workers - revisions to previous data show much stronger growth.

All these revisions offer a cautionary tale for investors trying to stay abreast of developments in the economy. For some reason, it appears the Department of Labor (DOL) is lately having more difficulty measuring payroll employment numbers.

The preliminary August payroll numbers were reported as being up 128,000 on September 1. This was revised up to 188,000 a month later and last week to up 230,000. Last week the DOL also revised September payroll numbers to almost triple their preliminary estimate, going from 52,000 to 148,000.

On top of this, the DOL recently told us that in the year ending March 2006, 810,000 more workers were on the nation's payrolls than initially reported. That means payrolls were underestimated by an average of 67,500 workers every month. The point is not to be critical of the DOL, but rather to illustrate how difficult it is to know how the economy is doing in real time.

The outlook continues to be tough for the housing market. Home builders are best positioned to know what is going on and their comments this week were quite negative.

- Toll Brothers is a large builder of up-scale homes and its Chairman and Chief Executive Officer, Robert Toll, said "we continue to look for signs that a recovery is imminent but can't yet say that one is in sight."
- Beazer Homes discussed "a challenging housing market...[where] most markets across the country continue to experience higher levels of resale home inventories,

lower levels of demand for new homes, significant increases in cancellation rates and significantly higher discounting.” To help ride out the storm the company reduced headcount by 25 percent and lots for building by 15 percent. Beazer added “we continue to believe that the long-term industry fundamentals, based on demographic driven demand and employment trends, together with further supply constraints, remain compelling.”

The outlook provided by the “leadership” of the National Association of Realtors (NAR) is more suspect. Their headline in a full page ad in the New York Times last Sunday read “It’s a great time to buy or sell a home.” The NAR spun the worrisome number of homes on the market into a positive image of how consumers have the greatest choice in decades.

What are the futures on Home Prices market telling us? This new market in Chicago gives a mixed, but mostly negative message. On one hand, the futures contracts project home prices in 10 major metropolitan markets will fall 7.5 percent from the quarter ending last June to 2007’s second quarter. The only silver lining is that the market is only slightly more pessimistic than it was a few months ago when prices were projected to drop 6 percent.

Looking at individual markets, investors are becoming more negative on New York, Washington D.C. and Miami; and more positive on Boston and Denver.

There are many measures of home prices and the Chicago futures are tied to the S&P/Case-Schiller Home Price Indexes (CSI). The methodology they use in the construction of these indexes is superior to most other indexes and gives a better picture of single-family home price trends. Unfortunately these indexes do not get much attention because collecting the sales data takes time and therefore their release is not as timely as other indexes.

Analyzing the CSI data for the first half of this year reveals another area of concern. In most years home prices get a noticeable seasonal boost in the spring, but for the most part, that bounce was missing this year. This has only happened twice in past twenty years, in 1990 and 2001. In 1990 housing prices fell during the next 12 months, but in 2001 while price increases slowed, they did not fall.

The impact of a weak housing market is already slowing the economy. It is estimated that the third quarter GDP would have increased 2.7 percent if housing construction had not fallen. In fact, residential housing construction fell at an annual rate of 17.4 percent, the biggest decline since 1991, and GDP rose only 1.6 percent.

Importantly for most investors, the stock market does not seem overly concerned with the housing sector’s problems. Most of the major indexes are trading near multi-year (and in some cases all-time) highs. Since we are well into the housing correction, I read the market’s action as saying the economy will be just fine in 2007.

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

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