Viewpoint

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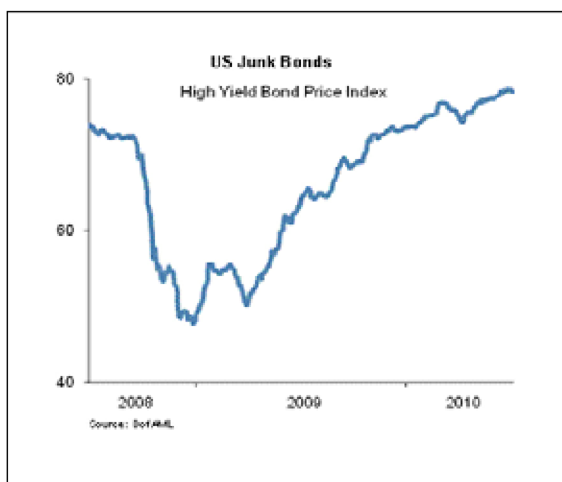
Housing And The Economics Of Sand Castles

By Anders J. Maxwell

May's capital markets are up blissfully, albeit after some extraordinarily volatile trading. Equity and credit markets are climbing to new highs from the current business cycle's low point in the second half 2008. The S&P 500 is up 34% in the past 12 months. High-yield bond prices have recovered from 50 to par. Corresponding bond yields have fallen from 23% to 8%. In short, this reversal is stunning. The financial press has naturally characterized the rally as presaging a meaningful recovery in the economy.



However, as these indices are hitting new highs, capital markets seem detached from reality. Two closely watched measures of economic activity - retail sales and manufacturing purchasing orders - are flashing warning signals. The International Council of Shopping Centers' index of monthly sales is projected down as much as 3% in April, while the ISM manufacturing index rose only slightly. It's speculated that the small ISM increase reflects supply chain restocking and accelerated orders in front of expiring tax credits, rather than sustainable demand. With retail spending accounting for about 70% of GDP and given that unemployment now hovers at 10% - a post-World War high - under the best of circumstances, consumption would be expected to remain anemic and weigh on markets.

What then explains the current elevated level of valuations, rather than the real economy, is the extraordinary expansion of the Federal Reserve's open market purchases (including $14 trillion of residential mortgages) and the Fed's ballooning balance sheet. These monetary initiatives account for the unprecedented level of liquidity reflected in the money supply, and record low interest rates.

Buttressing concerns over market valuations, based on any conventional metric - whether looking at price-to-normalized earnings, price-to-dividends, price-to-book, or price-to-sales - equity multiples on trailing results are well above long-term averages. Buyers, therefore, must be assuming growth in earnings exceeding 20% this year and next, completely at odds with sales growth projections for the S&P 500 of 5.5% this year and 7% next. Thus, whether on trailing results or unsubstantiated bullish forecasts, valuations are stretched to the limit.

There is clearly a sharp contrast between market perception and economic reality. The resolution as to where the economy is going has been housing and its banking companion, mortgage finance. This continues to be the case.

In due course fiscal and monetary props provided by the government will be eclipsed by the sheer weight of weak employment and faltering household incomes, in turn, depressing consumption, which drives the economy. More immediately, however, the broad-based collapse in housing - gathering momentum since 2007 - provides an unambiguous harbinger of what's ahead.

February marked the fourth straight monthly decline in new home sales - to the lowest rate since this series was initiated in 1963. Annual housing starts remain at record lows, around 600,000 units. Beyond these dismal production numbers, over one in four mortgages - roughly 11 million homes - are estimated to now exceed house value, reflecting 'negative equity' exceeding $800 billion. With homeowners seriously considering abandonment when value falls below 75% of their mortgage, it's forecast by Core Logic that between 5.1 and 7.4 million homeowners are likely to default this year.

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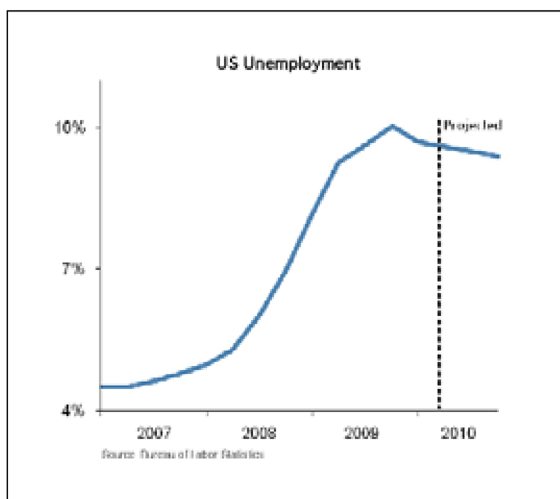
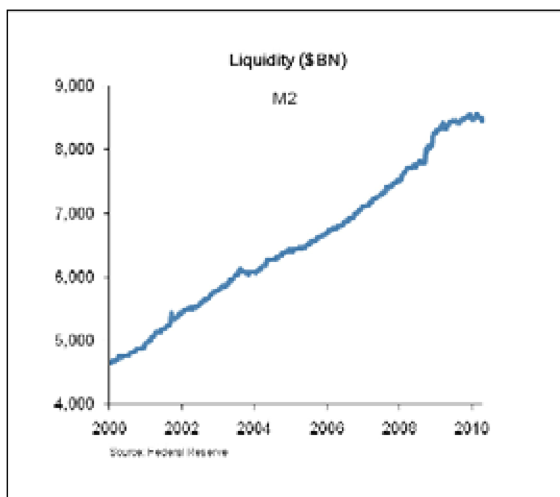
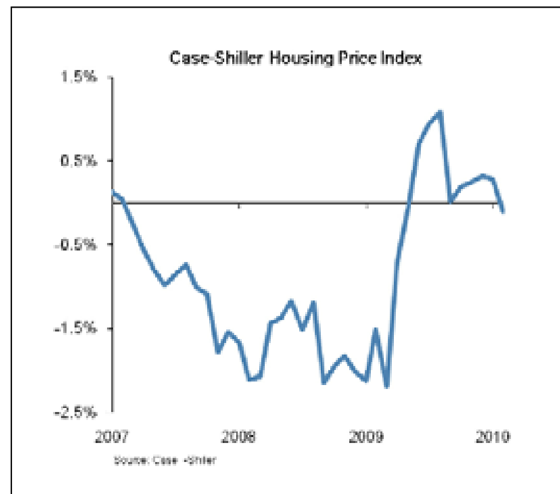
The housing picture is bleaker still considering that the source of over 90% of mortgage financing since late 2008, the Federal Reserve, effective March 31 withdrew from its program of open market mortgage purchases. This certainly can't be expected to help housing.





The end of the Fed's "quantitative easing" leaves housing primarily, if not exclusively, dependent for mortgage finance on the two government-sponsored enterprises: Freddie Mac and Fannie Mae. Together, the GSEs hold over half of all U.S. mortgage loans outstanding and accounted for 75% of residential lending in 2009. Both Freddie and Fannie survive today based solely on the largesse of the U.S. taxpayer. The federal government has advanced $130 billion to these entities. Following continued losses in the first quarter of 2010, GSE advances are expected to increase $19 billion, totaling nearly $150 billion this quarter.

Given these financing conditions, however Congress eventually resolves the future of these floundering agencies, it is clear that mortgage financing rates will have to rise, credit tighten and home sales remain under pressure.



Reinforcing the negative impact of a dysfunctional mortgage market, also stalling homebuilding and depressing prices, is a looming inventory of vacant homes. This reflects foreclosure rates now exceeding 12%. Based on 60-day delinquency rates around 7%, foreclosures seem certain to remain high. Based on these record rates and overhang of unsold inventory, there is every indication that housing prices will continue to weaken. In fact, prices

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dropped for the fifth straight month in February with the S&P Case-Shiller index falling 0.9%. This 20-city index is now 30% below its peak in 2006. The impact on the economy of this deterioration in housing may yet prove overwhelming. Well-documented by economists Karl Case, John Quigley and Robert Shiller, changing housing values drive consumption. As the continued decline in home values and net worth weigh on consumption, another period of economic contraction (and, correspondingly, fall in market values) seems preordained.

Given these self-reinforcing declines in home prices, decreasing home equity, rising delinquencies and foreclosures, coupled with a mortgage market in conservatorship, housing values are certain to depress spending for the foreseeable future. The foundation of U.S. GDP is consumption. As this lags, the economy will suffer and currently inflated capital markets are certain to see valuations drop.

Just as housing imploded once markets recognized the corrupting influence of free credit, so capital market values are destined to erode as surely as any castle built of sand.

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