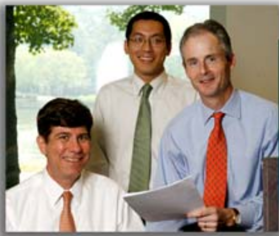

THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu January 31, 2011

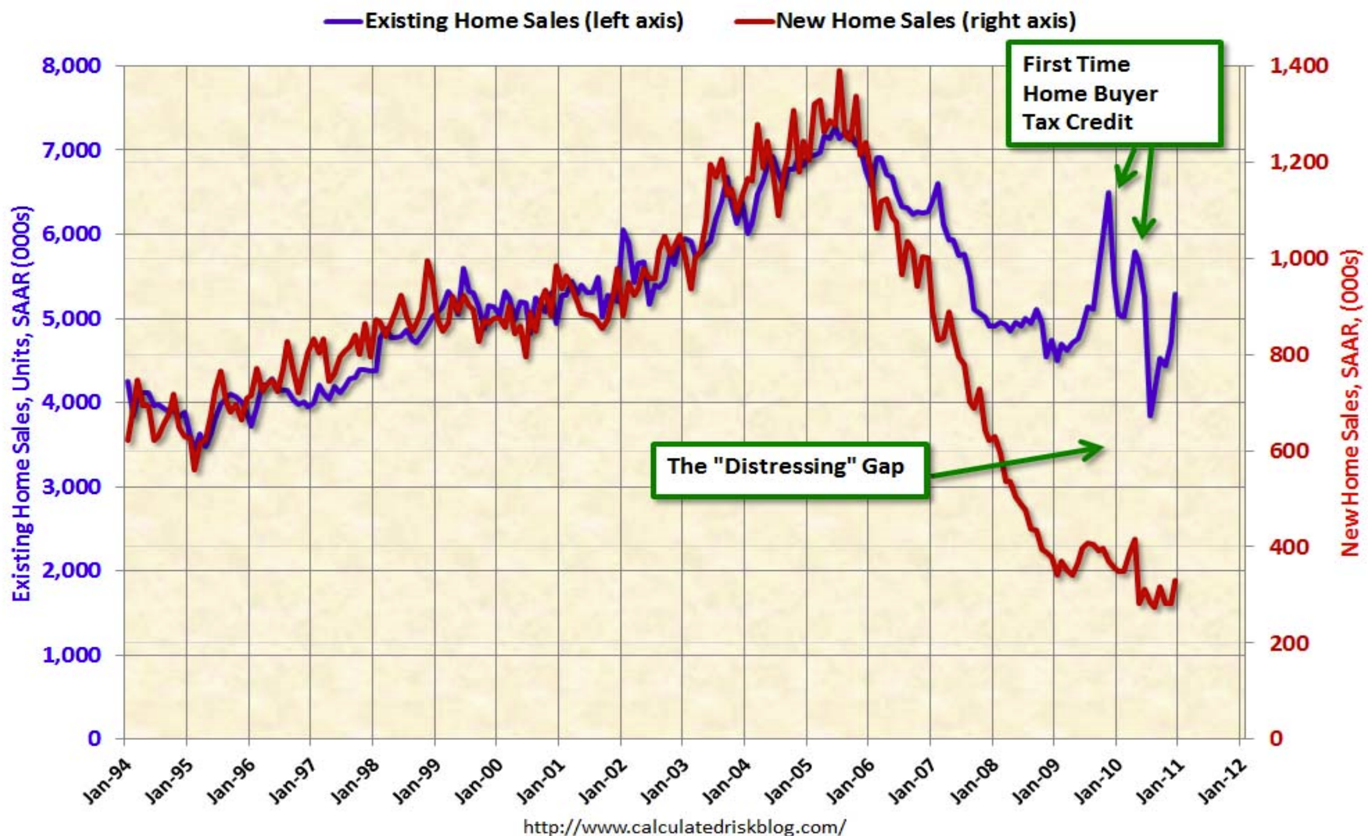
A Catalyst for a Correction

- The S&P 500 fell 1.8% on Friday and overseas markets fell 2.5 – 3%. We have been expecting something to trigger a correction for several weeks. First, the S&P 500 has rallied from 1000 to 1300 in seven months, in a trend channel rising at a 40% annualized pace, which we regard as unsustainable. Second, our favorite measure of short-term sentiment (the Ned Davis Crowd Sentiment Poll) has gone from extreme pessimism last summer, to extreme optimism in December. In our view, the protests in Egypt may have simply provided a catalyst. Given our views, we have reduced exposure to risk assets, bringing portfolios close to their benchmarks, and will use any correction as a buying opportunity when we judge the pullback has run its course. The events in Egypt, which we are hesitant to try to analyze at this early stage, were enough to cause the S&P 500 to break below our tight stop at 1180. Markets are rallying today, but if this is the correction we have been expecting, we think initial technical support is between 1120 and 1140. If the correction turns into something more serious, we expect support at the 200-day moving average — our proxy for the primary trend — currently at 1156.
- The first look at fourth-quarter US GDP was reported on Friday, coming in at an annualized rate of 3.2%, slightly below expectations of 3.5%. However, the report reinforced our conviction that there will be no double-dip recession in the US. Personal consumption rose 4.4% in the fourth quarter compared to 2.4% in the third, and nonresidential fixed investment (i.e., capital spending) rose 4.4%. Exports rose and imports decreased, thus trade contributed 3.44 percentage points to GDP. Government spending contracted by 0.6% but inventory drawdown was the biggest detractor to GDP, subtracting 3.7 percentage points from GDP. If inventories had remained steady, GDP would have been nearly 7%. GDP has exceeded its 2007 peak and is now expanding; according to ISI, expansions typically last three years or more. With GDP now rising close to its long-term trend rate, driven by consumption and capex, and despite negative growth contributions from government spending and inventories, **we think self-sustaining growth is becoming a reality** but expect the growth rate to decelerate from the fourth-quarter pace.
- One reason is that, in contrast to the overall economy, the housing market is still in distress. Our view is that home prices are within 10% of their ultimate low, but that further declines seem likely. While new home sales rose 17.5% in December to a 329,000 annual pace (well exceeding expectations for 300,000), a glance at our Weekly Chart shows that new home sales remain far below normal levels. In judging home prices we think it is important to differentiate between regular and distressed sales. Home prices fell for the fifth consecutive month in November, based on the S&P/Case-Shiller 20-City Composite Home Price Index; but another measure of existing home sales, the FHFA house price index, suggests that house prices started stabilizing for the past few months. This index attempts to eliminate the effects of distressed home sales.
- S&P/Case Shiller predicts that their home price index will fall another 7% to 10% through 2011 due to excess supply over demand, and we agree. Thus, more residential properties are likely to go 'underwater' with a mortgage balance higher than the home value. More homeowners facing such 'negative equity' — currently around 10.8 million, or 22.5%, of households with mortgages — could add to the roughly 8 million seriously delinquent homeowners, many of whom have not made a mortgage payment in more than two years, thus raising default prospects. For example, from the *Wall Street Journal*, "Twenty-three percent of those foreclosed upon in Nevada could've made their payments but chose to make a 'strategic default,' according to a report released [last] week by the Nevada Association of Realtors." Currently most delinquent mortgages are being subsidized by Fannie Mae and Freddie Mac, which continue to incur losses at taxpayers' expense. As the likelihood of a bipartisan resolution to Fannie and Freddie's growing debts is low, it seems increasingly likely to us that those entities will continue to make mortgage payments for underwater homeowners, further delaying a resolution to the housing crisis and keeping

downward pressure on house prices. Along with unresolved mortgage securitization irregularities this is likely to keep earnings and stock prices of banks under pressure.

- In conclusion, we see no quick fix for the housing market. Buyers are cautious, the attraction of home ownership is being questioned by the current generation of first-time buyers, and the result is that distressed sellers are pushing prices down. As foreclosure rates rise, we are hopeful that negative equity is finally peaking as the debt is written off by the lenders. As employment has stabilized, mortgage delinquency rates have eased to 13.5% from 14.4% in the second quarter. Unlike Japan, the US housing market is working out its problems through the pricing mechanism, as over-indebted homeowners sell to those with stronger balance sheets, a positive longer-term development. Furthermore, inventory levels have started to fall; with months-of-supply for existing homes at 8.1 months in December (down from 12.5 in mid-2010) and overall inventories of new homes falling to 190,000 units, the lowest since 1968.

The Weekly Chart: A slow workout, time is required



The chart above, courtesy of Calculated Risk, shows new and existing home sales, which had a close relationship up until the housing bust, at which time the "distressing gap" opened up. According to Calculated Risk, "the gap was caused by the flood of distressed sales. This kept existing home sales elevated and depressed new home sales since builders couldn't compete with the low prices of all the foreclosed properties." Until excessive inventories are cleared, distressed sales are likely to remain elevated and weigh on pricing. Home inventories are about 3.5 million; at current sales rates a more normal inventory level would be closer to 2.5 million.

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