



Housing Double Dip to Postpone Bond Bear

- In contrast to the overall economy, the housing market is deteriorating into a double dip. We think further declines in home prices are likely and S&P/Case Shiller's prediction that their home price index will fall another 7% to 10% through 2011 now seems like a best-case scenario. This will keep pressure on the financial sector, which has underperformed the S&P 500 by nearly 2% year to date, and especially for banks, which may be forced to keep more mortgages on their books and could potentially lose the biggest buyers of bundled mortgages—Fannie Mae and Freddie Mac. Furthermore, significantly stricter mortgage underwriting requirements will drive up borrowing costs, thus adding downward pressure on home prices in order for the market to clear. Ongoing housing market weakness will likely keep US GDP growth below 3%, new normal levels in our view.
- In this environment, it is hard to see 10-year Treasury yields rising above 4% this year. Thus, we see a 3.25% to 4% trading range. However, this does not make us want to change our allocation mix. We believe stocks have better short- and longer-term risk/reward characteristics versus bonds, so our bias is to further increase stock exposure. However, we think it does extend the current accommodative Fed pro-risk cycle (i.e., weak dollar, rising stock/commodity prices).
- Existing home sales fell 9.6% in February, the third largest monthly decline in 12 years. Inventories rose by 3.5% and remain relatively high at 8.6 months of supply at the current sales pace, up from January inventories of 7.5 months supply. Median existing home prices continued their three-year downtrend, falling 1.1% to \$156,100, the lowest in nine years and down 5.2% from a year ago. According to the National Association of Realtors, "Distressed homes – sold at discount – accounted for a 39 percent market share in February, up from 37 percent in January and 35 percent in February 2010." This will likely keep prices headed lower for existing homes and put pressure on new home sales.
- New single-family home sales fell to a seasonally adjusted annual rate of 250,000 in February 2011, 16.9% below the revised January rate of 301,000 and down 28% from a year ago. New homes are now selling at half the pace of 1963, even as the US population has grown by 120 million. New home inventories, after some encouraging declines in the second half of 2010, have risen to near early-2010 highs; months of supply increased to 8.9 in February from 7.4 months in January. However, looking at inventories another way, there is a potential silver lining for homebuilders when sales revive – the combined total of completed and under construction homes are at the lowest levels since records have been kept.
- Bipartisan support for a gradual reduction in housing subsidies appears to be brewing, primarily in the form of unwinding Fannie Mae and Freddie Mac. A February Treasury report outlined various methods to lessen the government's involvement and implicit guarantees in housing finance, while Republican lawmakers have repeatedly stressed private market solutions that would complement the Treasury's plans. There has even been talk of eliminating households' mortgage interest tax deductions. Unfortunately any decrease in housing subsidies, while less economically distortive, is likely to make the home-buying process less affordable. As banks have to assume greater balance sheet risk (versus taxpayers) to underwrite loans, they are likely to increase rates and fees, which we expect to keep downward pressure on home prices. We think that policymakers will tread carefully, recognizing these proposals could be disruptive. The key will be how effectively the private sector expands its role, given that there is an emerging consensus to whittle away at some major institutional pillars of housing finance (i.e., Fannie and Freddie). In our view, greater due diligence should lead to a healthier private sector mortgage market without substantially lowering the demand for loans, as more private funding options are made available.

- 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% from above 14% last year. 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. Thus, we expect an increase in homes being bought for rental properties as investors seeking steady income supply accommodation to younger families that prefer to rent.

The Weekly Chart: Gap due to excess existing home inventory

New and Existing Home Sales, Feb 2011



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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