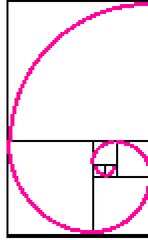

Sand Spring Advisors LLC

Hot Topics of the Day: Housing and Oil – Our Current Views

by,

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August 27, 2005

The myopic rear-view mirror economic mentality of Americans -- and particularly our bankers -- never ceases to amaze me.

Almost every day while driving my car, I listen to pundits on Bloomberg News Radio talking about the *natural* strength of the U.S. economy, and how GDP may still grow at 3% or more next year. Those commentators who are bearish dare only lower their forecast to 2% growth. No one that I have heard recently is forecasting an early 2006 recession. Instead, they are all focused on how the economy has been performing lately, but hardly ever ask the question: *why* has the economy performed this way, and will these conditions persist into the future?

In my mind this is a bit akin to another American tendency: knowing that terrorists have been setting off a lot of bombs lately, but hardly ever asking ourselves: *why* these people are so pissed off to do so? Instead we just call terrorists "evil doers" out to destroy democracy, and vow to fight back. The root *cause* of Arab-Muslim anger seems to constantly elude us.

Meanwhile, credit extended by banks as a percentage of U.S. GDP just rose above levels last seen in January 2000. And Bank of America somehow felt compelled to buy out MBNA at the peak of the credit card business in late June. Zero deposit-down and non-amortizing (and sometimes negatively amortizing) mortgages are the craze of 2005. "No Doc" mortgages have even appeared – where a higher rate is charged to reduce or eliminate income and asset verification. Somehow, all of these bankers just don't see that their very own comfort level in extending added credit and taking added risks at this point of the business cycle is really the last straw perpetuating an already squeezed U.S. consumer. These people seem to blithely ignore that the monetary conditions that drove the 2003-2005 equity and property market romp are already fading.

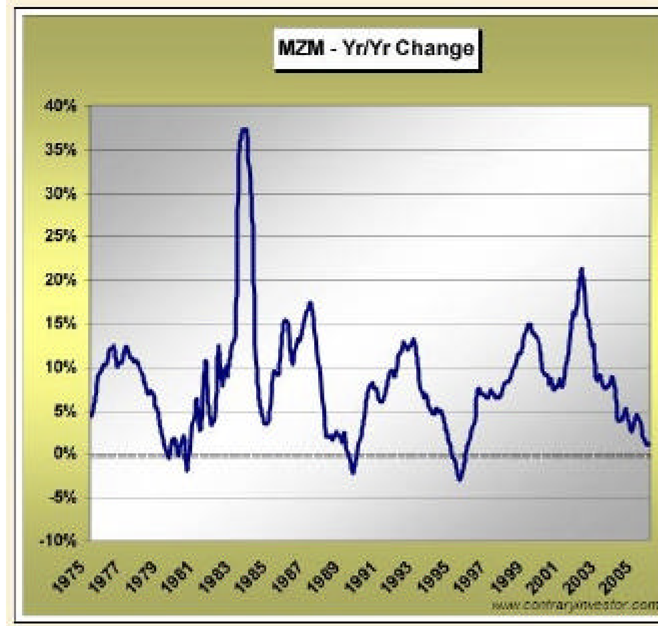
Let us consider the facts:

- the extraordinary stimulative monetary and fiscal pump priming of 2002-2003 is indeed now disappearing into the distant past; money supply is dropping and short-term interest rates are rising, with the U.S. yield curve nearly flat;
- the housing market – a key element in the boom of the past several years -- is starting to slide lower in price (even as absolute transactional volumes are still high and home mortgage credit is still easy to obtain);
- household debt liabilities as a percentage of income have never been higher;

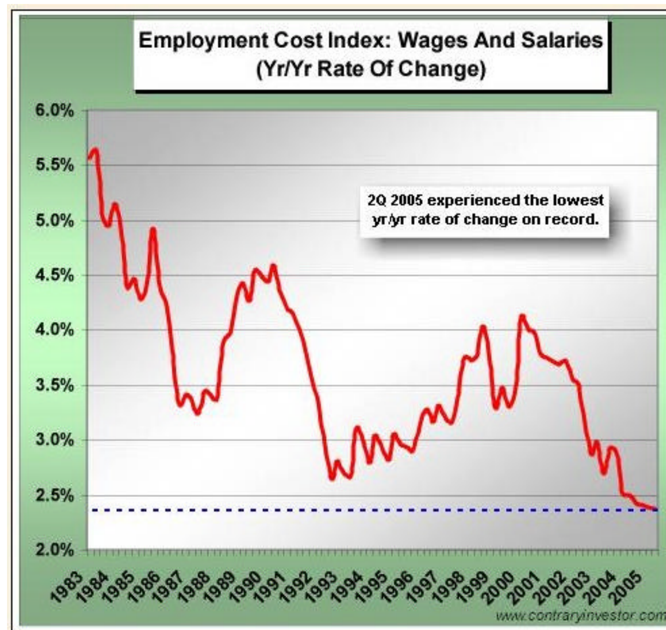
- wage earnings growth for the average household is still anemic (supporting corporate profits for now, but with signs of labor unrest building);
- inflation is rising, particularly at the gas pump

And for those that need to see things visually, not just in tabular format, here are a few accumulated favorite views of ours to really understand the current environment – to understand how misplaced it is to simply extrapolate the recent economic past into the future. Some of these views are courtesy of the absolutely wonderful website ContraryInvestor.com. Others come courtesy of Northern Trust's Chief Economist Paul Kasriel.

First, money supply…With the Fed restrictive and rates headed higher, MZM is not growing:



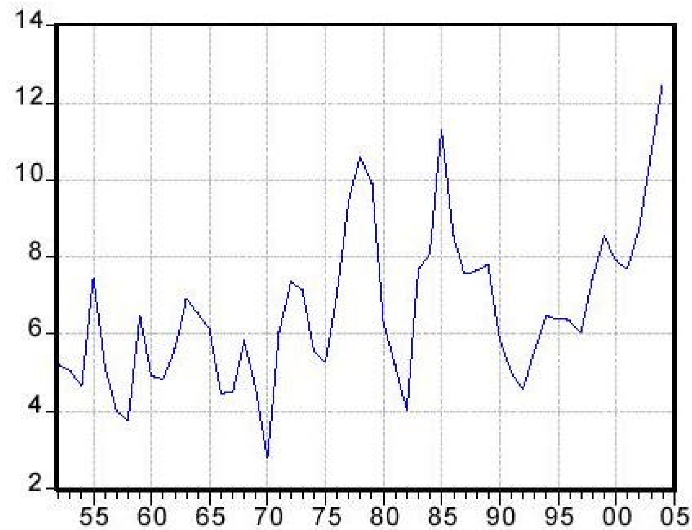
Nor are American wages:



Yet the consumer *has* kept spending – at least until recently when certain retailers and restaurants have started to report weakness – and consumers have perpetuated their spending mostly by going into more debt. Ditto the acquisition of financial assets. For every stock and bond that people have bought, somewhere behind the scenes, a wild binge of financial borrowing has transpired. This is <u>not</u> a sustainable or even normal economic expansion. The charts below suggest people buying time not to transgress on their desired lifestyle, but eventually being exposed to a major hangover of debt servicing.

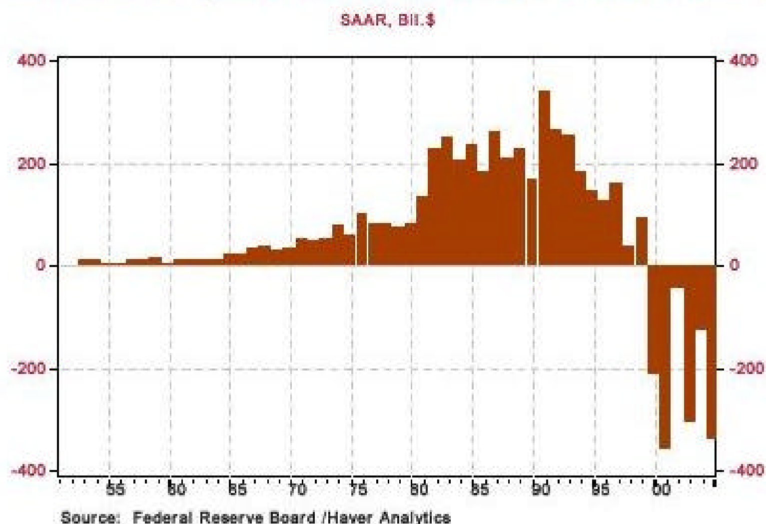
Chart 1

Households: Change in Liabilities ($) / Total Spending* ($)
%



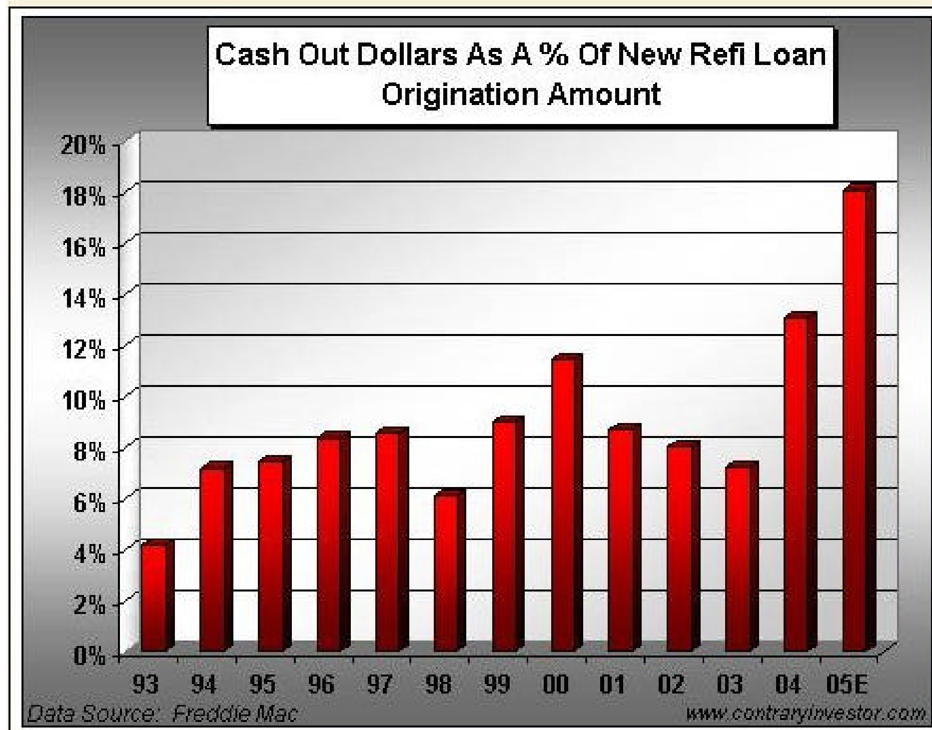
* Sum of Personal Consumption and Private Residential Investment Expenditures

Households: Net Acquistion of Financial Assets minus Net Increase in Liabilities



Source: Northern Trust Company

What has allowed these conditions to continue as long as they have? The 2002-2003 fiscal and monetary stimulus certainly started the process – got the ball in motion so to speak. Then the ball got passed to our bankers and mortgage lenders who relaxed their credit standards. And the consumer scored the touchdown by perceiving an easy deal -- turning easy credit into higher property values and ready cash. Mortgage refi activity currently remains a source of much liquidity as the chart below of Cash Out Dollars as a percentage of New Refi Loan Origination Amount shows:



So thereby we come front and forward to the topic of real estate. Is there a real estate "bubble" or is there not? This is a hot topic of discussion these days. With regard to the housing market, and its importance in the current environment, just consider the following facts prepared by Merrill Lynch analyst David Rosenberg looking at data from the National Association of Realtors:

- Real estate has accounted for 70% of the rise in US household net worth since 2001;

- Over a third of homeowners apply over a third of their income to mortgage payments; 12% apply half of their income;

- Over 40% of the private sector jobs created since 2001 have been housing related;

- From 1955 to 1995, in real terms after inflation, U.S home prices rose 0%. They have increased 45% since 1995, which has increased paper net worth by $5 trillion.

- Despite booming real estate valuations, owner equity as a percentage of real estate assets currently stands at a historic low -- a full 12% lower than in 1982 at the beginning of the 17.2-year boom between August 1982 and early 2000.

- Despite short-term rates going up in 2005, 32% of new mortgages this year have carried adjustable rates;

- An estimated 25% of total new mortgages and 42% of mortgages taken out by first-time homebuyers *had no down payment* in 2004;

The last of those stats pops out as truly amazing to our eye. And yet early signs of a slowdown in real estate – at least as an attractive investment asset -- already abound:

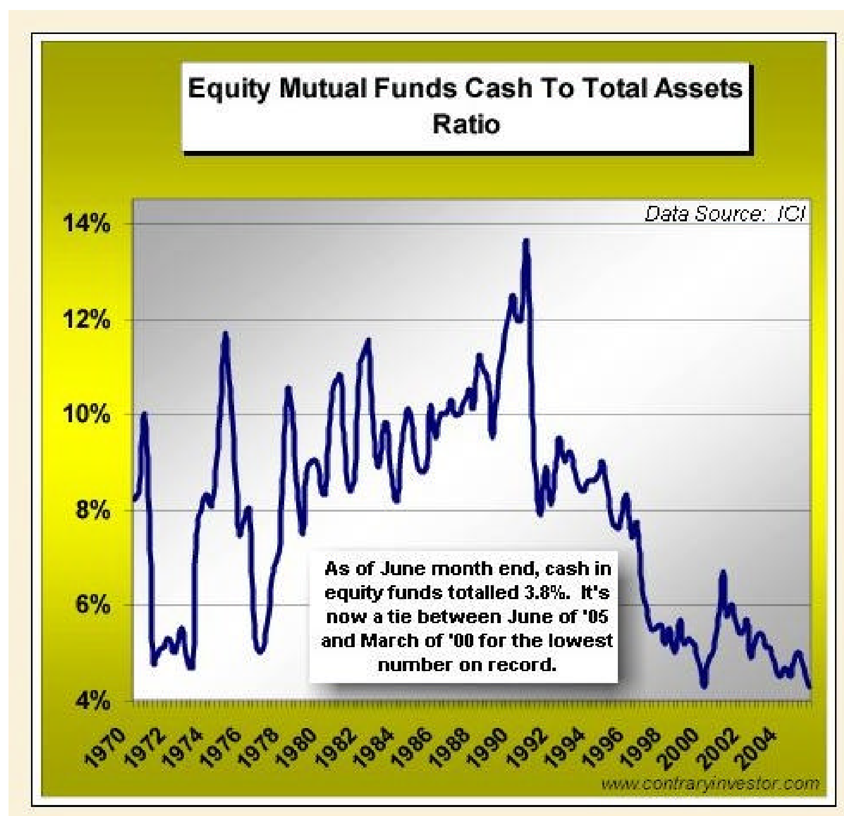
- The inventory of unsold homes is now 15% higher than it was a year ago;
- In the condominium sector -- which is where speculation has been the greatest -- supply has recently ballooned to 5.3 months.
- In July, the average sales price of homes fell by -2.6% from the prior month, even as transaction volume remained high. Yet even sales stats data are starting to be suspect. A recent NAHB survey showed single family home sales dropping to their weakest level in several years and potential buyer traffic falling off as well.

Real estate is real estate. As a tangible asset, it is not going away – people have to live somewhere, and the population is growing. But there is no doubt in our mind that a bubble does exist – at least most certainly in the credit markets supporting the acquisition of real estate.

At some time an inflection point will be reached where interest rates will be high enough, consumer resources to service the debt stretched enough, and property values lofty enough, that a point of entropy in real estate demand will occur. In our mind, that time may have already occurred, but people simply don't want to admit it yet.

And if real estate prices start falling, and the ability to extract cash out of refis abates further, just from where will the next dose of consumer liquidity and spending ability come?

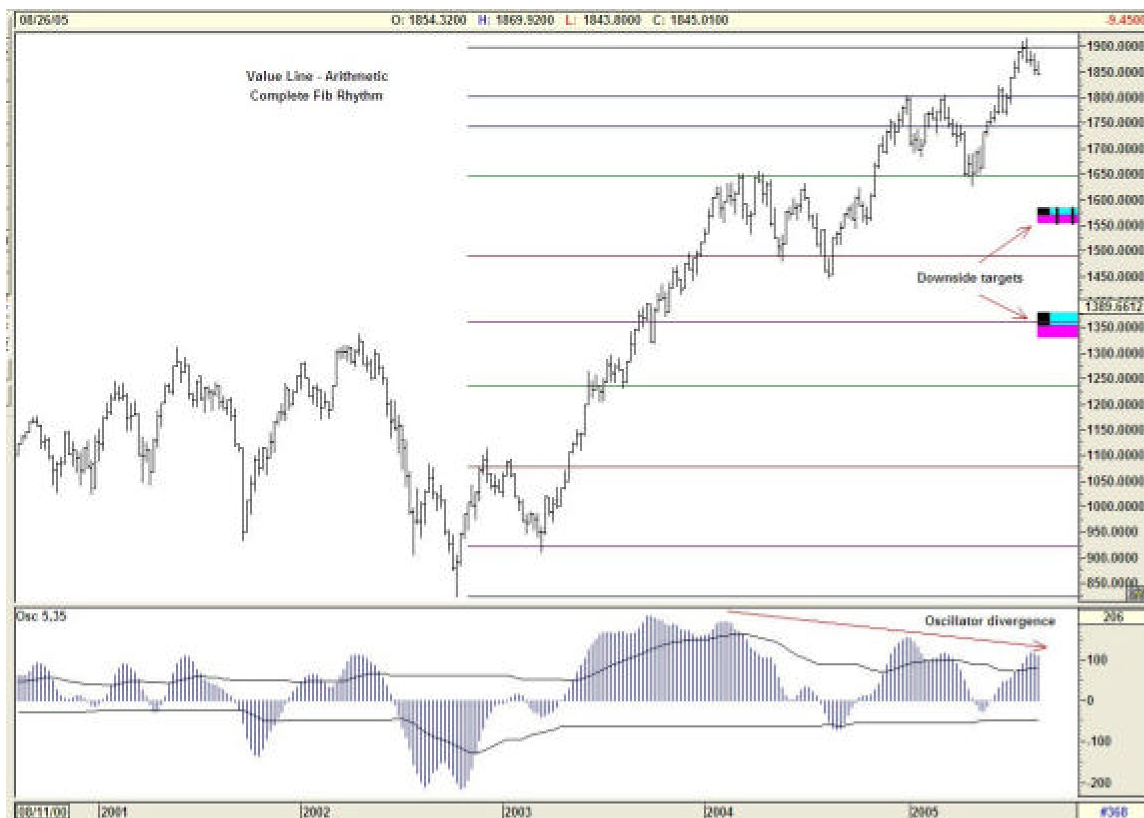
And when the consumer starts to stagnate, just who will be left to buy equities as corporate earnings start to slow? Certainly not the mutual fund community! As a final interesting fundamental perspective, mutual fund free cash levels now stand at the low levels last seen in March 2000:



But most people simply ignore all this. The large majority of our population, brokerage community, and economic commentators fail to focus on the facts. They espouse instead that since the economy has been strong, the likely path is that it will continue to be strong. This is such myopic backward-looking foolishness.

To our technical eye, stocks like Beazer Homes, Toll Brothers, and Pulthe Homes are all great candidates for longer-dated put buying (we mention puts because these stocks are awfully volatile to just be outright short). Ditto retailers and restaurants (as discussed in previous issues). Levered financial companies should with time follow these other sectors down. Beware of steep forthcoming declines in stocks like Bank of America, Wells Fargo, Golden West, Accredited Home Lenders, Americredit, and Capital One.

But perhaps the clearest technical picture we now see in the major stock indices shows up in the small-cap heavy Value Line Arithmetic Index which recently made new highs. The Fibonacci rhythm here combined with negative divergence on the 5-35 day oscillator is a harbinger for trouble. We have marked two downside targets on the chart below.



Now we must admit that within the very short term 60-minute chart of the Dow Jones Industrials (not shown), we do see some support at around 10,375 – perhaps still offering a bounce potential from current levels into the Sep. 19, 2005 PEI cycle date. But if 10,375 on the Dow gets blown away in a flush, then watch out below. Per the work of cycle maven Bill Erman of Ermanometry.com, August 31st might be a minor low into a brief bounce period, but overall, we do not want to be too tricky here and risk missing the 4.3-month move lower by trying to play any small 2-3 week potential bounce. The overall trend in equities is lower until late January 2006. At that latter time, instead of real estate and crude oil being hot topics in the media, we fully expect the word "recession" to be all over Bloomberg News Radio – even if it isn't right now.

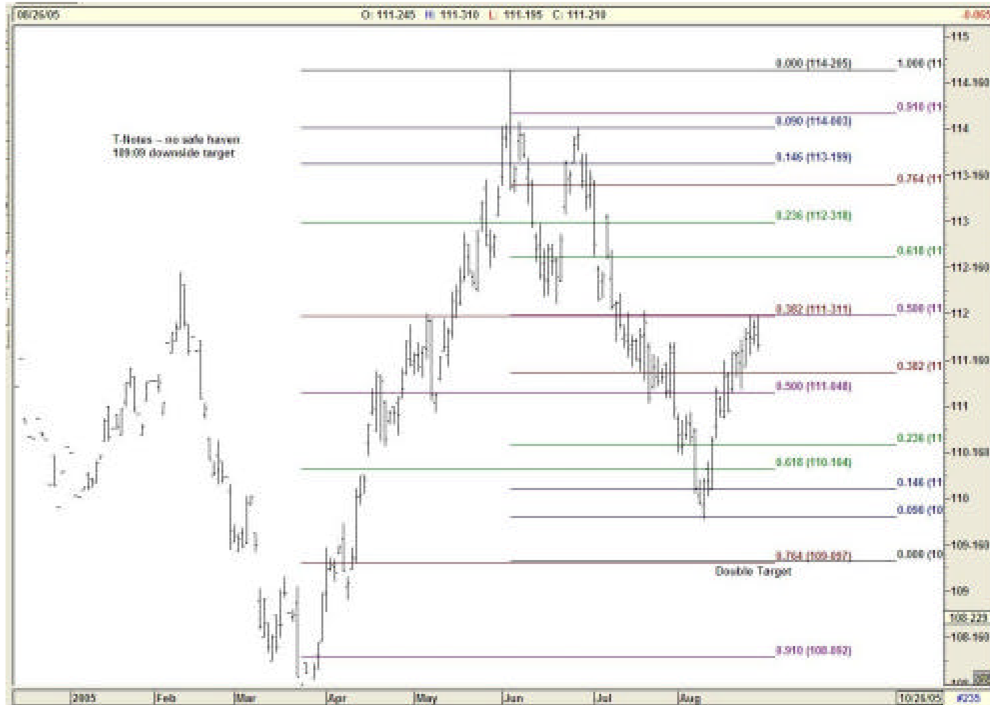
On the topic of crude, another common view at present is that because energy prices have recently been going up, they will continue to go up. On this second topic, we certainly admit that physical crude

supply is very tight and subject to both supply dislocation (from terrorist acts, refinery fires, and hurricane-induced shutdowns) as well as potential demand side shocks (typically hot or cold weather-related). But as our Sep 19th PEI cycle date approaches, we find ourselves wondering if Crude Oil is not getting a bit technically overdone and due for a top. Interestingly, the week of Aug, 29, 2005 does represent the 21st cycle of 8.6-month mini-pi cycles from the major August 1990 crude price high.

Looking at the hourly rhythm of Oct'05 Crude futures, and stretching our Fibonacci bands up from the late May 23, 2005 Crude oil pivot low, we see an extrapolated line of resistance now for Crude near $70.70. Could next week -- or perhaps the PEI equity cycle date on Sep. 19th -- bring such a high? We will certainly be on the lookout for a Crude reversal if $70.70 is approached during either of these periods.

Elsewhere in other markets, as we put pen to this paper, silver appears to be breaking lower, but gold continues to sport a definite Fibonacci rhythm that points to an upside target of $472-$475. So the metals markets are currently sending mixed signals. We await these two markets to get more in synch before commenting further.

And if Crude were to top in coming days, yet equities are set to fall until January, where should one hide? T-Notes perhaps? Absolutely not -- at least for now. As also pointed out recently by ContraryInvestor.com, there has been anemic 2005 buying of Treasuries from foreign central banks – and net sales of U.S treasury debt out of Japan since November 2004. Within the chart rhythm of September T-Notes shown below, a missing low down near 109:09 still appears to beckon for the U.S. T-Note contract.



So where to hide? We've suggested water stocks in the past, but they have run too far in the short term. The only chart that continues to appeal to us is that of the yen – where we fully expect to see a 96.66 print against the dollar sometime early next year. Yen's 21st 8.6-month cycle rhythm from the Aug 1998 high in the dollar specifically hits February 20, 2006.

Overall, it's going to be a confusing and volatile fall and early winter – with many cross-currents. Stay tuned. Any modifications to our views over time will certainly find there way to the website.

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