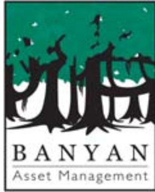

"An Eye On Housing"

Market Commentary – October 2007

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The U.S. economy, as measured by Gross Domestic Product (GDP), grew a revised 3.8% in the second quarter of 2007. Economic growth has been boosted by relatively healthy jobs and wages. Unemployment is near a six-year low at only 4.6% and personal incomes rose 6.8% in August versus a year earlier. Inflation-adjusted consumer spending rose 0.6% in August, which was the best reading in two years. It is questionable, though, how sustainable consumer spending will be going forward.

The housing market continues to struggle on many fronts and appears to be getting worse.

- Housing starts plunged 19.1% year-over-year to a 12-year low. Building permits, considered a leading indicator of new home activity, declined to the lowest level since 1995.
- Unit sales of new homes fell 8.3% in August to the lowest annual rate since June 2000. Unit sales of existing homes fell 4.3% to the lowest annual rate since August 2002.
- The median price of new homes plummeted by 7.5% in August year-over-year, the biggest drop since December 1970.
- Borrowers going into foreclosure increased at a rate of 0.65%, the highest in 55 years of surveys by the Mortgage Bankers Association. In total, 1.4% of all mortgages are in foreclosure.

Many are estimating that 2008 will see the residential real estate market turn around, but there is much room for disappointment with this view. Each month through the end of 2008, interest rates on tens of billions of dollars in adjustable rate mortgages are scheduled to reset, likely higher. The first half of 2009 will see a lull in resets, but then there is a second wave of massive rate resets lasting until the second half of 2011. If homeowners cannot afford their mortgage payments, they will be forced out of their homes.

In a move that favorably surprised the stock market, the Federal Reserve cut its benchmark Fed Funds rate by 0.50% to 4.75% on September 18. Wall Street had been expecting a 0.25% cut. The Fed said that the action "is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets". They added that "the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally." The Fed is trying to stop the economy from sinking into recession. Stocks soared on the news with major U.S. market indexes rising from 2.5% to 3.7% in one day. Futures markets are pricing in an 82% probability of an additional 0.25% reduction in the Fed Funds rate to 4.50% by November, and a 56% chance of yet another 0.25% cut to 4.25% by January. The next scheduled interest rate decision by the Fed is planned for October 31.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 17.9, giving an earnings yield (E/P) of 5.57%. Compared to the 4.58% yield on the 10-year Treasury note, stocks still offer somewhat attractive valuations. With third quarter earnings season about to kick off, Standard & Poor's predicts a 3% increase in average profits for the S&P 500, compared with growth of 8% year-over-year in the second quarter. Our proprietary market breadth indicator turned positive on September 4 and has hit a plateau in slightly positive territory. Aside from the high volume spike on the day the Fed cut interest rates, volume has been light. Weak volume suggests less conviction behind the market's move.

In this market environment, we continue to own stocks that we calculate to be undervalued. Speculative growth companies have been very hot in recent weeks. Investors in these stocks, including some mutual funds and hedge funds, are enjoying the reward of their speculation. At some point, however, the risk side of the equation will become more evident. Value investing is not always exciting, but over time we believe it offers more favorable risk and reward parameters.