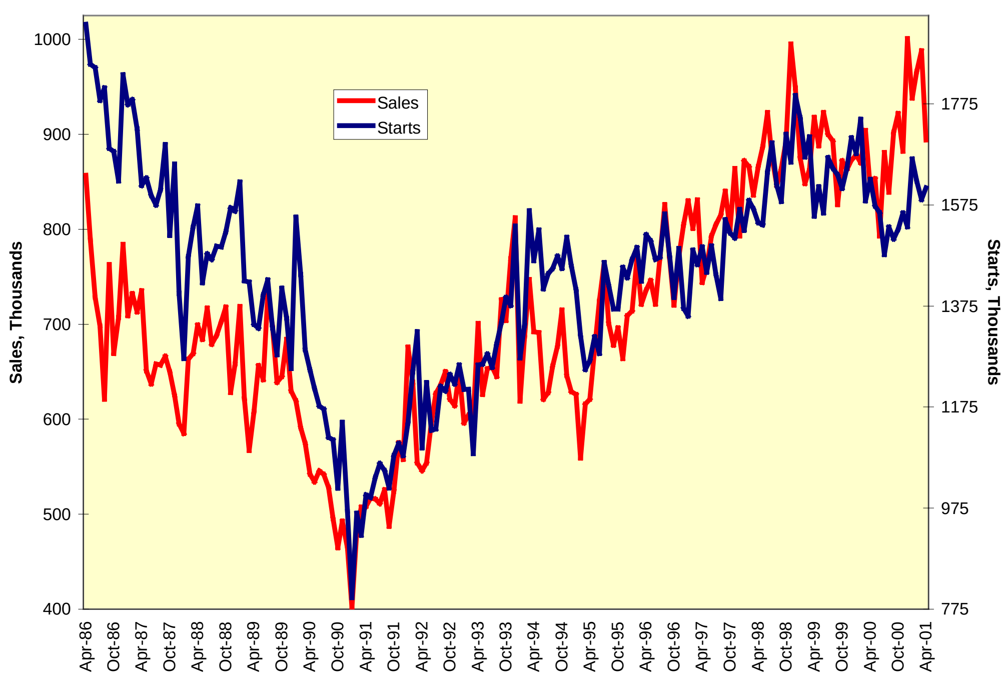
Lumber: Bringing Down The House

The economic slowdown that began last fall with a collapse in capital spending in the technology sector has been unique. Unlike previous recessions, this one left two of the most important and interest rate-sensitive industries, housing and automobiles, relatively unscathed until now. In fact, several strong housing reports led to selling in the stock market on the theory this would discourage the Federal Reserve from further cuts in interest rates.

Unfortunately, we seem to be running out of luck in the housing sector. Not only have long-term interest rates moved up 60 basis points since their late March lows, the price of lumber has jumped since it hit nine-year lows in February: The price of 2x4 studs and sheets of oriented strand board (plywood) have risen 210% and 172%, respectively, in 2001. Much of this price volatility has been due to uncertainties surrounding the extension of the 1996 Softwood Lumber Agreement between the U.S. and Canada. This pact, which expired in the end of March, supported U.S. lumber prices by restricting Canadian exports; U.S. importers kept inventories low in anticipation of a flood of Canadian wood, but this surge in exports has yet to materialize. As a result, U.S. builders have been bidding prices higher in anticipation of continued strong demand, even as both interest rates and unemployment have turned higher.

For this reason, last week's report on the 9.5% drop in new home sales from March to April came as such a surprise to those who accepted the argument we were avoiding a recession. The recent strong pace of new home sales had not spilled over yet into new housing starts – unsurprisingly, sales tend to lead starts – yet both the lumber market and the shares of key homebuilders both anticipated a strong rebound in starts in 2001. After all, short-term interest rates have been lowered 250 basis points so far in 2001, and can't the Fed fix anything and everything?

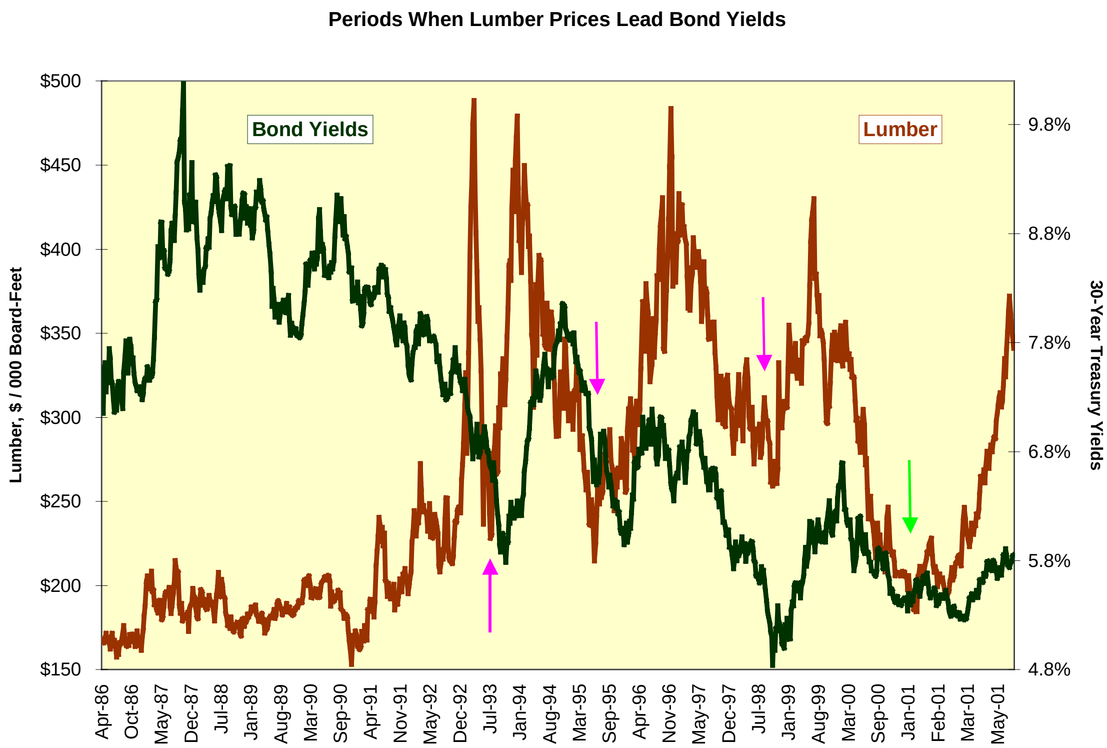
Total National Housing Starts And New Home Sales



A Double Whammy

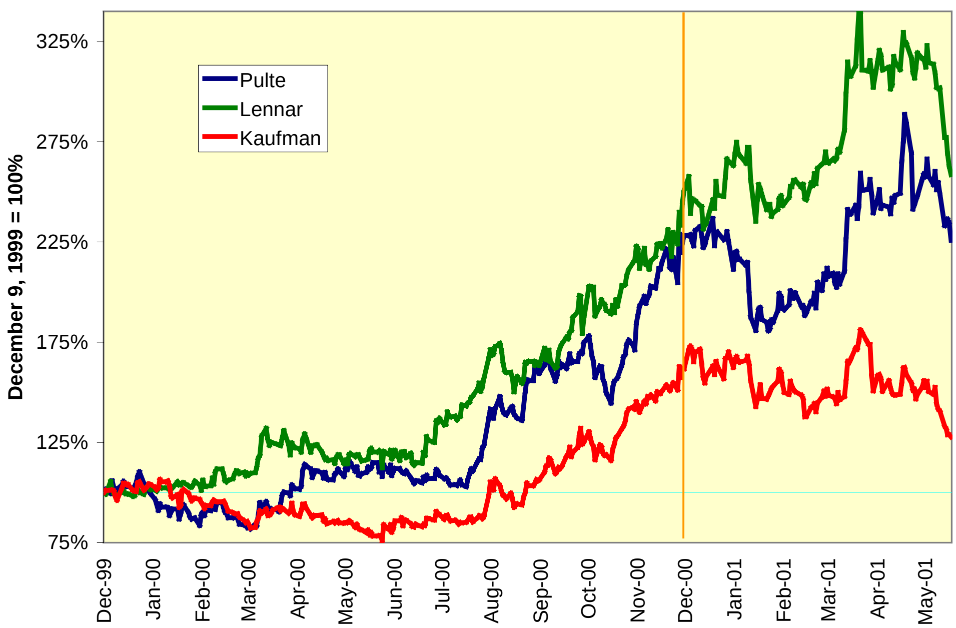
The Fed's rate cuts might have helped housing if they were at the correct end of the yield curve. But, the aggressive rate cutting has increased inflationary expectations, *even as current inflation remains under control.* This can be measured by both the spreads between ordinary and inflation-protected Treasuries (see "Fear Inflation Now," Real Money, February 2001) and by the steepening yield curve itself. Since home mortgages are issued at maturities far longer than federal funds, the net contribution of interest rates, which are higher at the 10-30 year maturities than they were at the start of the year, to the housing market has been negative.

As noted in this space last December, (see "Lumber: Making Board Level Decisions") the relationship between lumber prices and bond yields is a complex one. However, the jump in lumber prices thrice led bond yields higher during the 1990's; this is consistent with new housing plans preceding increases in credit demands. These periods are denoted on the chart below. The first and most massive jump in lumber prices, in spring 1993, is associated with the spotted owl court case that restricted logging in the Pacific Northwest and created a supply bottleneck; this jump is excluded from the discussion. The other three jumps in lumber prices, in summer 1993, fall 1995, and winter 1998, all occurred within stronger economic conditions and all presaged rises in long-term interest rates. The present period is different: The jump in lumber is occurring within a weak economy. Perhaps the present jump in lumber prices is temporary, and perhaps the subsequent rise in interest rates won't be as great as in previous episodes. But that's trading by hope. This page adheres to the view we are in for a bear market in bonds (see "Waiter! There's A Bear In My Bonds," April 2001).



There's No Stock Like Home
Last year's combination of falling bond yields and low lumber prices allowed the stocks of homebuilders to outperform the S&P 500 by a substantial margin. The correct conclusion reached here last December was these days were going to come to an end soon.

Payback Time: Performance Of Selected Homebuilders Relative To S&P 500



Since the early December time of that writing, the group has shown some interesting tendencies. Its relative performance dropped drastically after the January 3rd rate cut, but then surged during the February-March selloff. Kaufman & Broad has underperformed the S&P since last December, and Pulte Homes has provided market performance in an erratic fashion. Lennar, which has boasted a gaudy one-year return of 99.7%, led the group higher into early April, and has turned sharply lower since.

Moving forward from here, homebuilders should see continued difficulty. How can a combination of higher interest rates, higher lumber prices, and a slower economy encourage strong growth in housing sales and starts? Of course, a weaker housing and/or automobile sector will set off alarm bells at the Fed. The equity markets will take that as good news, for a few days, at least. However, this game's getting a little old: After five rate cuts and a tax cut so far in 2001, the S&P 500 and NASDAQ are still down 3.2% and 8.9% on the year. How much more of this can we afford and still keep a roof over our heads?