# Homebuilders' Optimism: No Gimme Shelter Here

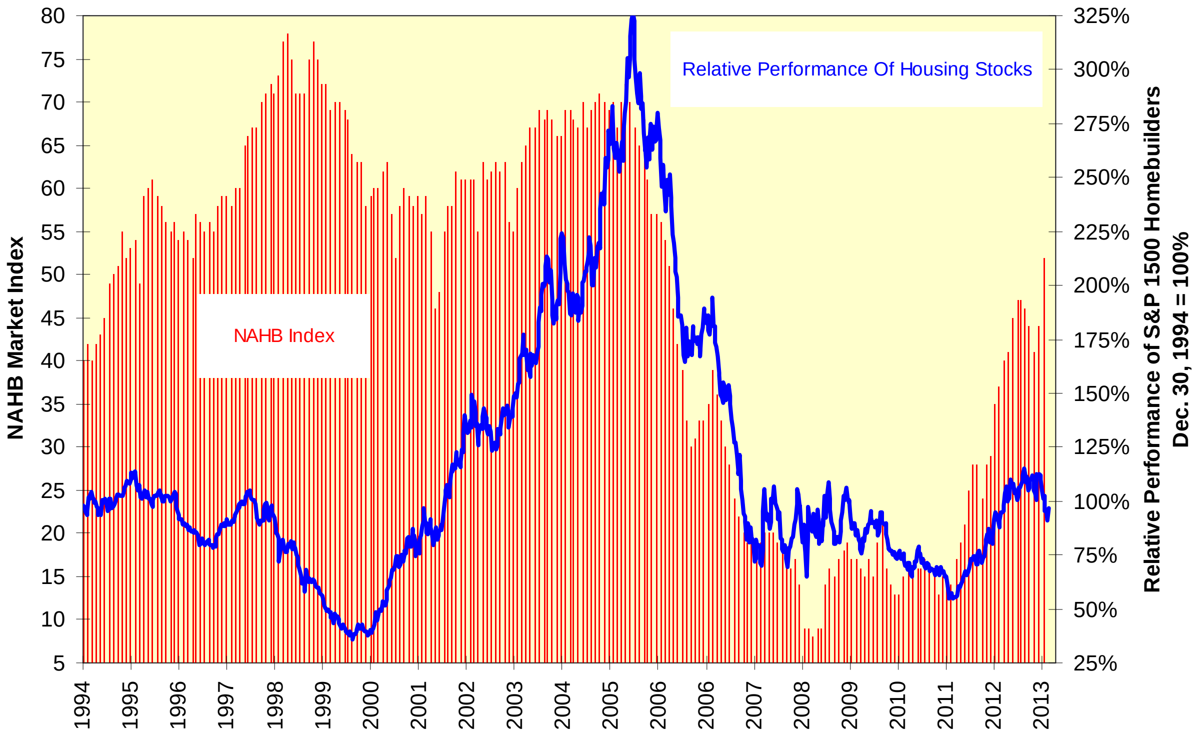
Certain businesses just attract optimistic people or at least demand a bullish outlook to remain in good standing amongst peers. I never once met a wheat grower who thought the price was too low and the term "Texas hedge," meaning being long both the cash and futures markets simultaneously, referred originally to the cattle and not the petroleum business. While I cannot prove it, I would guess Aubrey McClendon would still being pushing Chesapeake Energy's (CHK) drilling program today if he had not been figuratively wrapped in burlap.

Such attitudes may be for the best, actually. I used to tell students they had better see the reflection of the biggest, baddest trader in their screens; otherwise, why should they be doing this? Homebuilders, our subject here today, fall into the whole future's so bright they have to wear shades category.

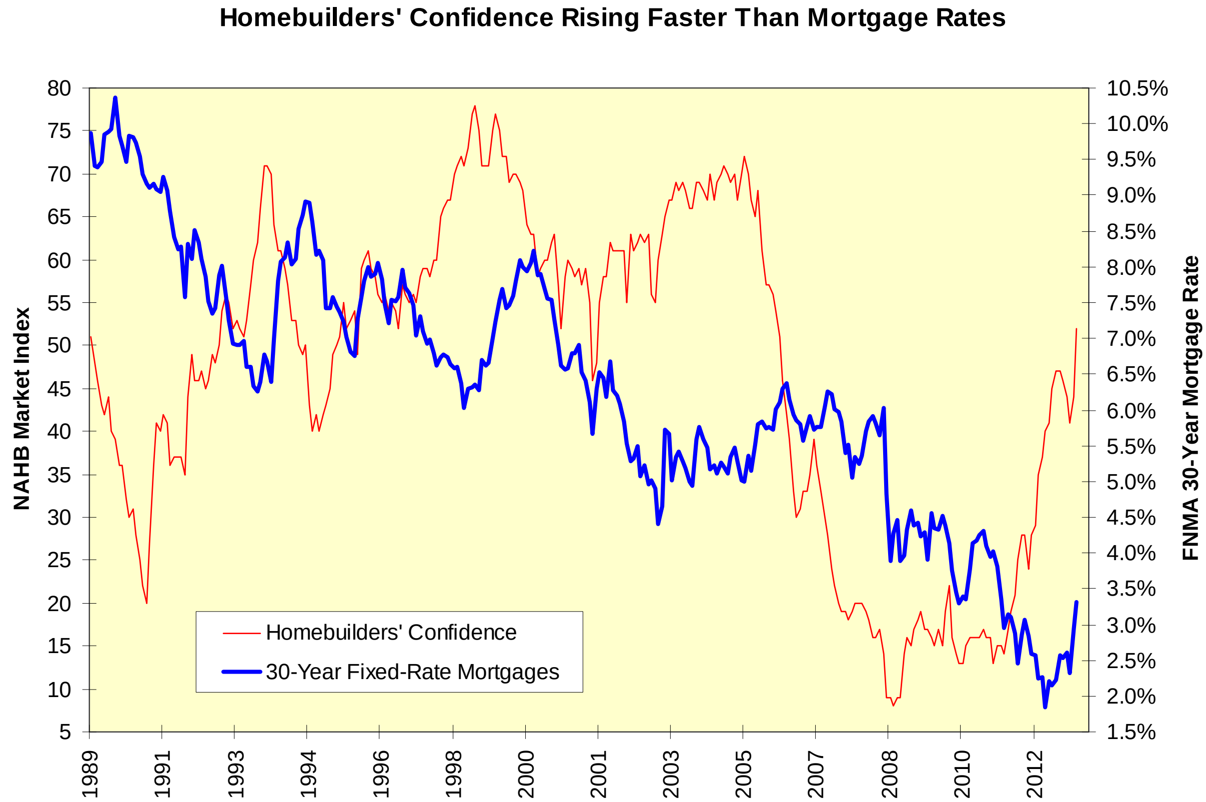
**How Bullish Are You?**

The National Association of Homebuilders surveys builders on their perceptions for sales and prospective buyer traffic for the next six months with readings over 50 being positive. That index was in the perma-bullish range between 1994 and June 2005, at which point it turned negative and stayed there all the way until last month. However, sentiment has been improving since September 2011. Moreover, the builders' confidence led the performance of the S&P 1500 Homebuilders index relative to the Supercomposite itself. That index includes industry stalwarts such as D.R. Horton (DHI), KB Home (KBH), Lennar (LEN), Pulte (PHM) and Toll Brothers (TOL).

**Homebuilders' Confidence Advancing Ahead Of Relative Performance**




The NAHB index also has moved higher even as 30-year fixed-rate mortgages have become more expensive. The jump in mortgages is a very recent phenomenon, and rates are still low by the standards of recent years. However, if mortgage rates continue to rise and personal income continues to advance at or near its most recent 3.3% annual rate, affordability will drop. Pent-up demand from first-time homebuyers and from those seeking to move up the shelter-chain, my made-up parallel to the food-chain, will keep demand propped higher for a little while, but we should have learned the hard way last decade what happens when home affordability becomes stretched.




**If You Want To Trade Bonds, Trade Bonds**

Homebuilders, like utilities, have become bond proxies. They peaked recently on May 15, 2013, one week before the Federal Reserve embarked on its homage to the *Temptations'* Ball of Confusion tour, and then dropped 19.1% into the aftermath of the June FOMC meeting. They then had one-day advances of 5.54$ and 7.14% on July 9th and 11th, respectively.

This is all well and good and is done, no doubt, between consenting adults. But just as it was always idiotic to trade major integrated oils such as ExxonMobil (XOM) or Chevron (CVX) off of one-day moves in front-month crude oil futures, it makes no sense to trade homebuilder stocks off of one-day wonders in either direction in long-term interest rates. Homebuilding is a long-term business with multiple variables affecting its profitability; why use them to execute your opinion on interest rates when cleaner and simpler alternatives are available?

The builders are optimistic; they almost are duty-driven to be so. The relative performance of homebuilders had been on a six-month decline in anticipation of declining affordability. Either the industry survey is wrong or the stock market is wrong. As an economist, I am duty-driven to go with the stock market.