Homebuilders' Little Pink Houses

"Ain't that America, home of the free / Little pink houses for you and me"… John Mellencamp

Being an astronaut must be fun, even if NASA manages to lose the home movies of one of humanity's greatest achievements. You get to see things from above and in perspective. You can do the same thing on a much smaller scale by staring slack-jawed out of an airplane window and wondering if they sell toothpaste in your destination city.

I used to have to fly into Tulsa, OK, on a modestly regular basis. Eastern Oklahoma has more lakes than Minnesota, and Tulsa, which is on the Arkansas River, is a seaport. Both facts are attributable in large measure to Senator Robert Kerr, chairman of Kerr-McGee, who served in the Senate between 1949 and 1963 and who was Lyndon Johnson's right-hand man in rounding up the votes. As chairman of the Select Committee on National Water Resources, he took payment in dams. The point is made: You can see what a U.S. Senator is capable of doing from space.

Changing Fortunes For Homebuilders

Fly into any major city today, and if your memory is long enough, you will see urban sprawl extending much further than before. The point is made: You can see what monetary policy and the Federal Reserve are capable of doing from space. Their grand social experiment in driving interest rates lower between 2001 and 2004 when the first rate hikes began, softly and slowly, to remove the stimulus for credit-dependent industries such as homebuilding.

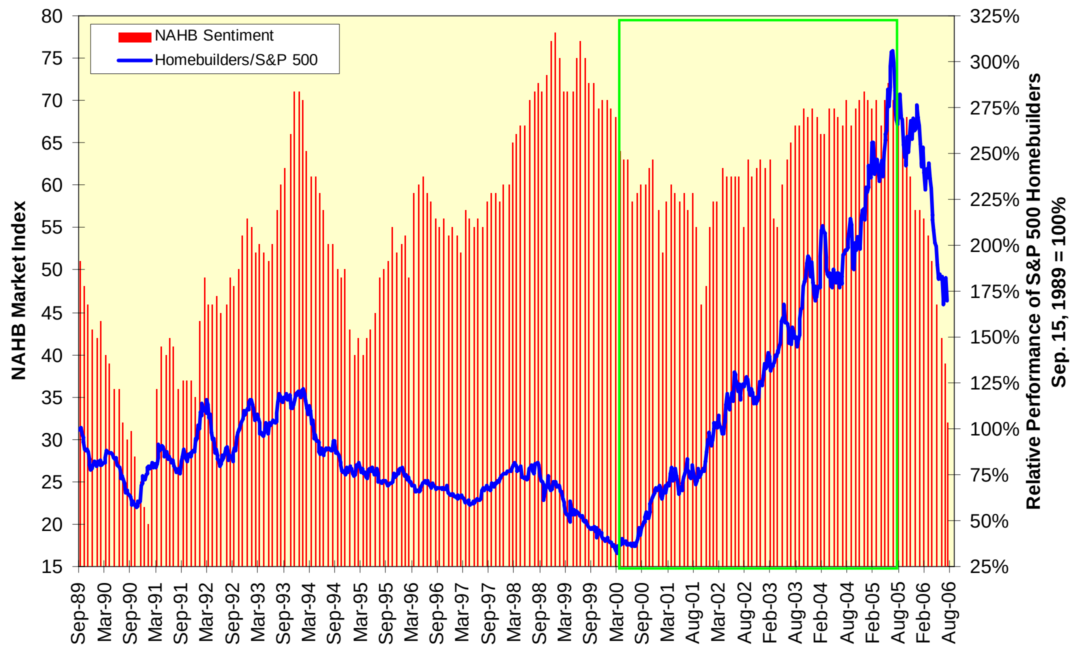
This is exactly how interest rates are supposed to affect the economy; in theory, interest rates equilibrate between future and present consumption. Higher rates discourage present consumption in favor of future consumption, while lower rates do the exact opposite. And markets do move to excess: It was not enough for some that a few marginal homebuyers could now qualify for some plain-vanilla 30-year fixed-rate mortgage, no; we had to jam anyone who could fog a mirror into undocumented option adjustable-rate mortgages. We shifted a lot of housing-related investment into those years and created a boom for homebuilders.

Oddly enough the beneficiaries of this boom kept a level head if the National Association of Homebuilders sentiment survey is to be believed. This index, which recently hit a low of 32, spent most of the time between March 2000 and August 2005 between 55 and 70. During this time, the relative performance of the S&P 500 Homebuilders index to the S&P 500 as a whole did nothing but rise in a straight line. Incidentally, the last time this column addressed homebuilders specifically was in August 2005; the negative action then was attributable to rising mortgage rates.

The homebuilders could have gotten giddy, at least in their sentiment survey, but chose not to do so. Homebuilders have seen booms and busts before, and they were determined not to confuse a bull market for brains.

If only Wall Street kept such a clear head. A casual observer might think there are some out-of-control egos in this business.

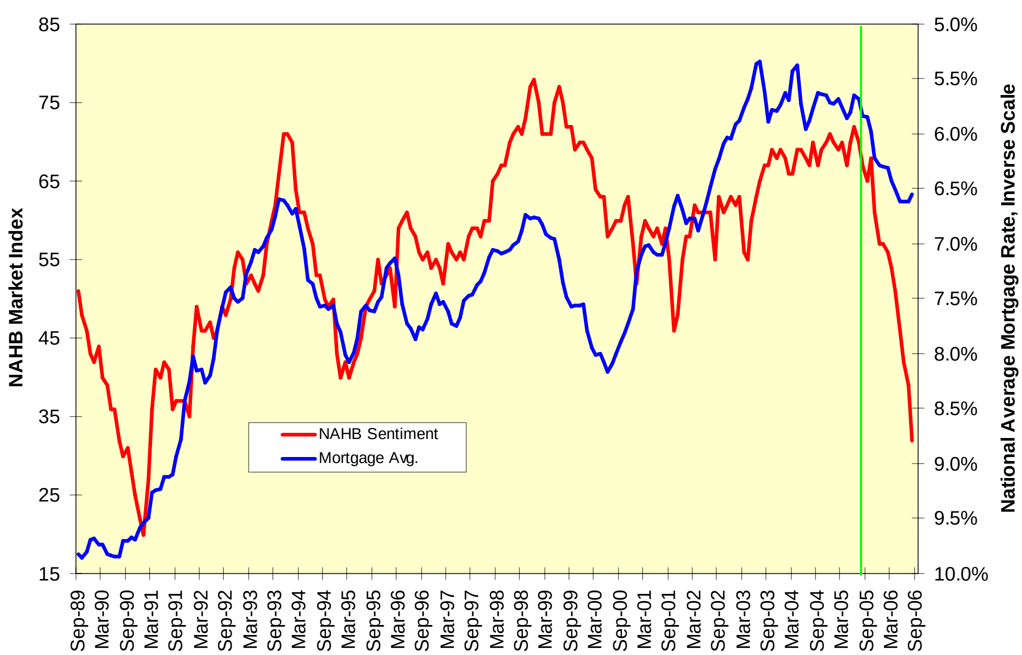
Homebuilders' Confidence Asymmetric Between Boom And Bust



The Interest Rate Connection

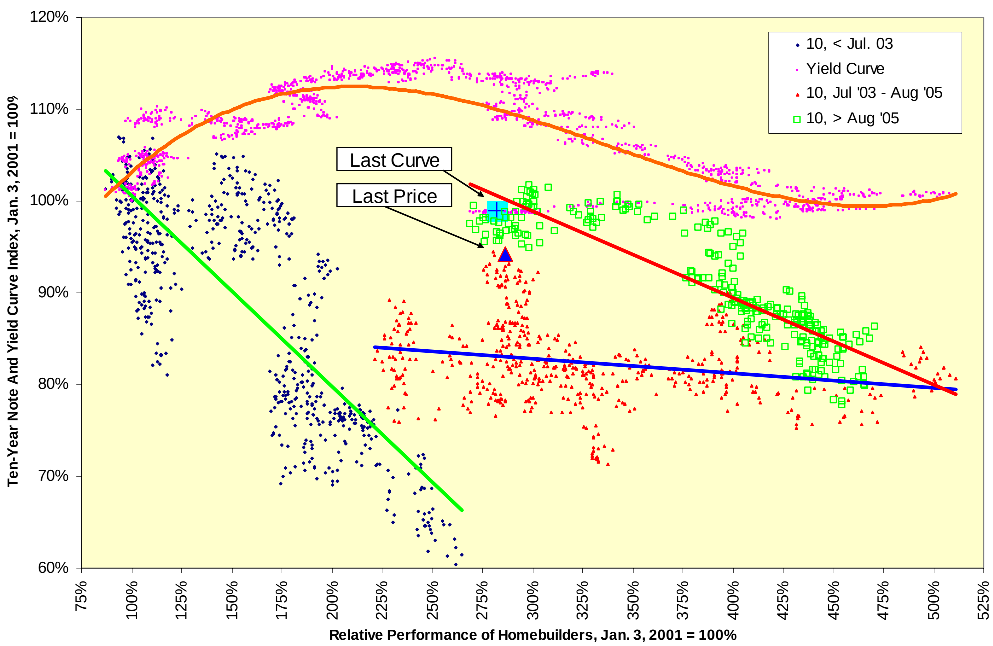
But if they kept cool on the way up, they certainly have panicked on the way down. The relative performance of their stocks has fallen, and with it so have their spirits. While you may think they are manic-depressives without the benefit of the occasional mania, they actually are reflecting the abyss created by the interest rate mechanism discussed above. Prior to August 2005, their sentiment index reflected the national average rate for fixed-rate mortgages so well that it was simply a redundant indicator. But what the small rise in mortgage rates, from below 5.5% to above 6.5% did was close the door behind the flood of marginal new homebuyers who had flooded into the market. The builders satisfied 2006-2007 demands in 2002-2005. They will have to wait for the next wave of homebuyers, and given how homes define durable goods, that may take many years.

Rise In Mortgage Rates From Low Levels Destroyed Confidence



Another way of looking at this interest rate relationship is by updating and expanding a complex chart from the August 2005 column on homebuilders. The rate-cut era began in January 2001. We can divide the next five and one-half years into three regimes, the one prior to July 2003, the one after August 2005, and the one in between these two. If we map the relative performances of the homebuilders against the relative movements of ten-year note yields and superimpose trendlines on them, we see how both the pre-July 2003 (green trendline) and post-August 2005 (red trendline) periods show strong dependence on interest rate trends. The middle segment (blue trendline) had only a weak relationship to rate trends.

Ten Years After: The Yield Curve Effect



We can also map the relative performance of the homebuilders against the shape of the yield curve as measured by the forward rate ratio from two to ten years in the chart above. This is the rate at which we can lock borrowing in for eight years starting two years from now. During the pre-July 2003 period, the yield curve was fairly steep; the homebuilders as a group tend to do well in a steep yield curve environment. The present yield curve is quite flat, which works against the homebuilders. Overall, we have to conclude the group is left wishing for a combination of lower long-term rates, a steeper yield curve and a stronger economy. While nothing is impossible, this combination is unlikely to occur anytime in the foreseeable future.