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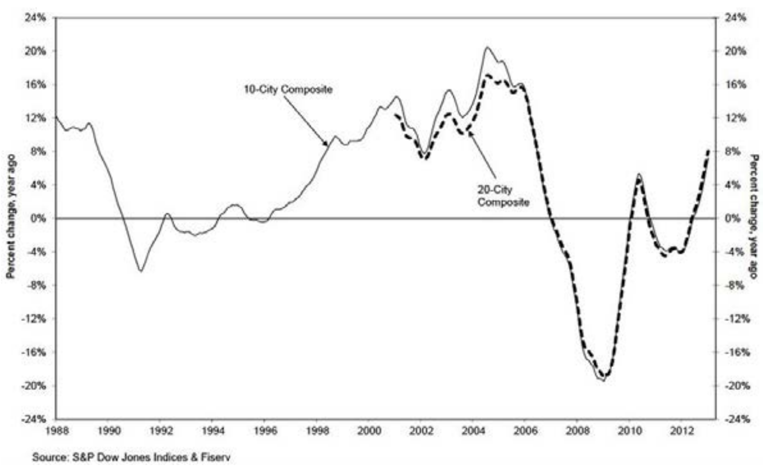
Harry Houdini Economy

"I don't want realism, I want magic!" – Tennessee Williams

Which is the illusion: the tepid economic recovery or record stock market levels? As the disconnect between the real economy and the markets has continued to widen, it is sometimes difficult to tell. While equity indexes have hit an all-time high, the broader economy has muddled along clocking sub-par historic growth. This disconnect, which was the subject matter of our previous newsletter, *Over FED*, has confounded and frustrated investors around the globe. Over the past few quarters, however, a silver lining in the murkiness (and a potential bridge to this disconnect) has been revealed. This potential bridge is none other than the recovery of the residential housing market.

Figure 1: S&P/Case-Shiller Home Price Indices [2]

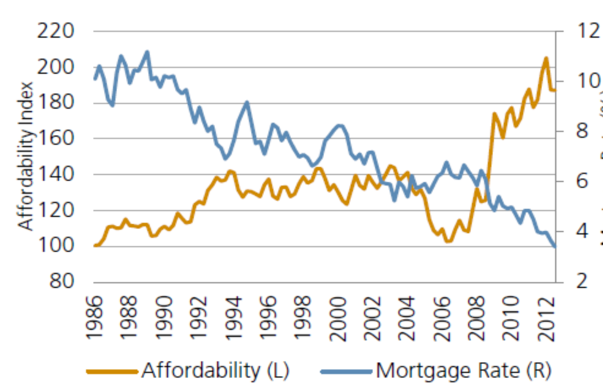


By any measure, housing prices across the United States are seeing nascent signs of recovery (see Figure 1). According to Robert Shiller, the famed Yale economist, "The housing market is very different from the stock market. (Prices) have momentum and when they start going up, they generally keep going up for a year of even more." [1] Although it has taken seven years, 2012 saw housing finally return to being a positive contributor to GDP and concurrent improvements in all 20 major metropolitan areas contained within the Case-Shiller Index.[1] This renaissance in housing raises as many questions as it does answers: *What's behind the resurgence?, Why is it so important?, Is this rally real and sustainable?* And most intriguingly, could the one thing that got us into this mess really be the thing that gets us out of it?

What's Behind the Resurgence?

Just about every gimmick in the book has been used in an attempt to revive the housing market since the economic downturn began in 2008. The Federal Reserve has done everything in its power to keep monetary policy very accommodative. Its Quantitative Easing programs (1-3), Operation Twist, and lowering of the Fed Funds Rate have all helped create an artificially low interest rate environment conducive to a rebound in housing. The impact of low interest rates is significant as can be seen in Figure 2. In late 2008 (before the Fed intervened), rates for 30-year fixed mortgages were around 6.1%. A borrower who qualified for a $1,000 monthly payment could get a $165,000 mortgage. Today, with rates closer to 3.5%, that same borrower can get a mortgage as high as $222,000, increasing purchasing power by one third.[4] While these actions have not been a panacea to the overall economy, there is evidence that they have, in fact, been stimulative to the housing market. Elsewhere on the Federal level, the current Administration and various Departments (namely the Treasury and HUD) have attempted to pull rabbits out of their own hats by introducing a number of programs designed to aid underwater borrowers and stabilize the country's housing market. The Making Home Affordable (MHA) program and its seemingly endless array of underlying programs with equally titillating acronyms (HARP, HAMP, MIP-grandfathering, 2MP, and HHF) have also yielded some positive results. Delinquencies are down, re-financings are more broadly available, and foreclosures and short-sales are not having as much of an adverse effect on the market as they were a few years ago.

Figure 2: Homebuyer Affordability Index and Mortgage Interest Rates [3]



The mortgage rate is the average rate on U.S. 30-year fixed-rate mortgages
Source: National Association of Realtors, Freddie Mac, as of 31 December 2012

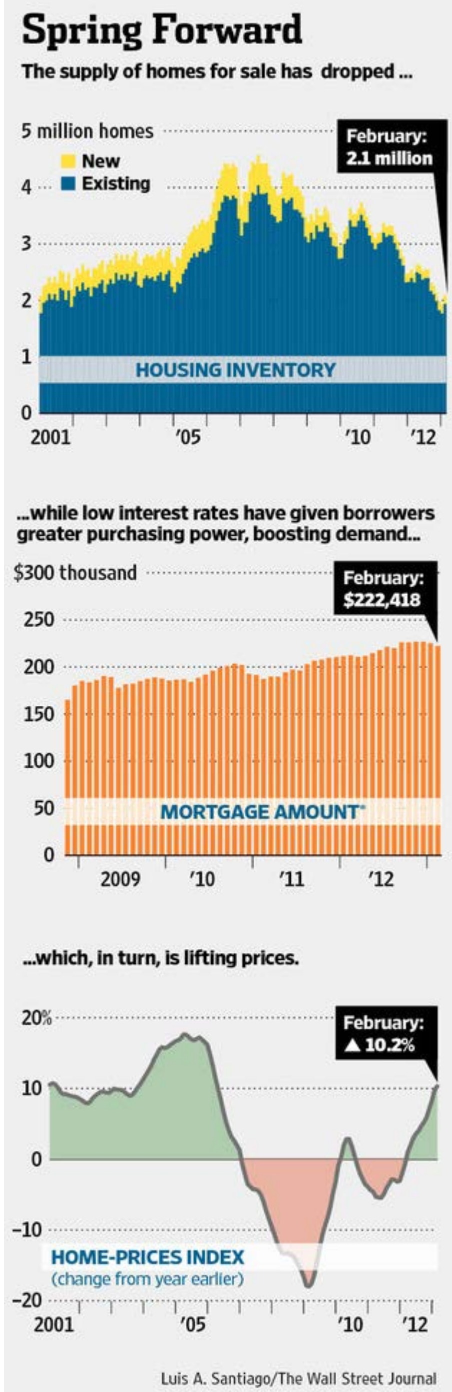
Of course, the Government hasn't done it alone. At the end of the day, the Government cannot mandate a real, long-term housing recovery; it can only create a backdrop for it to take hold. Still, there are countless other, more organic, factors at play that have also served to buoy the housing market as of late, three of these being: pent-up household formation, investor purchases, and simple supply-and-demand.

One important factor is pent-up household formation. It has been over five years since the economic downturn began in early 2008. That's five years of 20-somethings living with their parents or sharing apartments with friends. That's five years of 30-somethings putting off upsizing to more family-friendly (i.e. larger and more expensive) homes. From 1997 to 2007, household formation averaged 1.3 million per year. During the financial crisis the rate plunged to 357,000, and at the end of 2012, the rate was at 973,000, still more than 300,000 below the pre-crisis 10-year average.[3] As the overall economy has backed off from its 2008 ledge and the jobs picture has become somewhat clearer, this pent-up household formation is beginning to work through the bottleneck.

Another organic factor at play, and somewhat surprisingly, has been increased investor interest. According to the National Association of Realtors, about a third of the homes purchased in this housing recovery have been purchased by investors.[5] This is one of the main differentiating features between this recovery and ones in the past and, in part, why famed Reagan Administration economist David Stockman ominously calls this recovery the "Housing Bubble 2.0". An extreme example of this has been Blackstone Group (NYSE:BX). According to The Wall Street Journal, Blackstone has been buying about $100 million worth of single family homes a week since early last year, spending a total of $3.5 billion to date.[5] In instances like this where large institutional investors have entered the market, they have often sought out entire underwater neighborhood developments in some of the hardest hit cities and states.

Maybe the most important of all the organic reasons behind the resurgence is simple Econ 101: supply-and-demand. For the first time since the housing crisis began, demand has actually begun to exceed supply. There are many reasons for this, and as always with supply-and-demand, the two are inextricably linked. On the supply side of the equation, new construction has been muted for years. While housing starts are up, they haven't increased enough to even compensate for housing obsolescence. Further, what new construction there has been has centered on multi-family dwellings, as the uncertainty surrounding the economy and jobs picture has favored renting, as opposed to buying. In fact, inventories of single-family, non-distressed existing homes are at 11-year lows, which is less than five months of supply at the current pace of purchases.[3] On the demand side, in addition to themes like pent-up household formation and investor purchases, there are a number of psychological (or behavioral) catalysts. For one, the wealth effect created by recent gains in the stock market has left some investors feeling more secure about their financial well-being and willing to spend it. And even more, with increased clarity of the economic landscape and interest rates still at all-time lows, there has been something of a gold-rush mentality out there with some would-be purchasers feeling the need to hurry up and buy now while a low mortgage rate can be locked in.

Figure 3



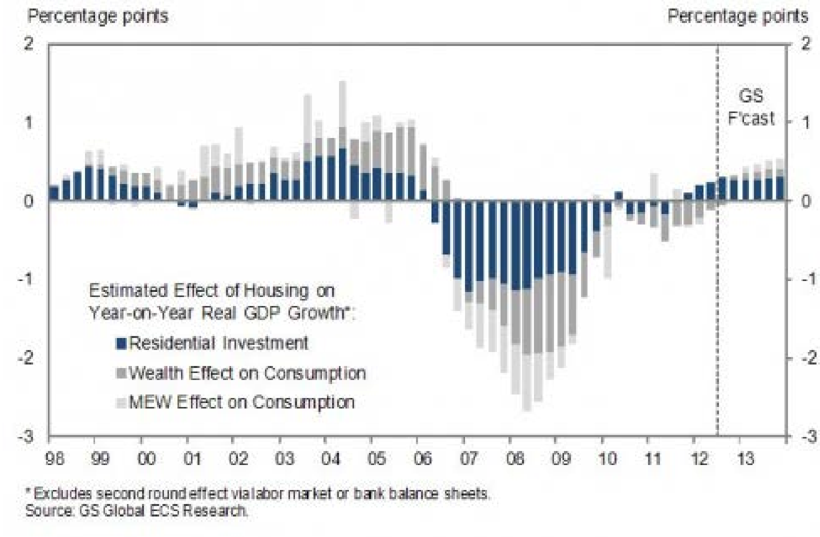
*For a 30-year fixed-rate mortgage with a $1,000-a-month payment at prevailing interest rates

Sources: National Association of Realtors; Commerce Dept; John Burns Real Estate Consulting; Federal Reserve; Freddie Mac; CoreLogic

Why is housing so important?

With residential housing as a percentage of GDP historically averaging roughly 5% prior to the financial crisis and just under 3% today,[6] one might wonder why all the fuss about housing in the first place? *Is it really that important?* The short answer is yes. For starters, one must not forget that housing was the first to falter back in '07 and went a long way towards putting us in the mess that we have been in for the past five years. With its countless reverberations throughout the economy, housing has a multiplier effect that makes its impact far greater than it may initially seem on the surface. Just think about it; housing holds sway over everything from furniture to consumer electronics to raw commodity prices to banking/finance. Stepping back to a more macro level, it has an impact on job creation, property tax receipts, consumer confidence, and more. According to the National Association of Home Builders, each new home creates an average of 3 jobs for a year,[7] and Russell Price, a senior

Figure 4: The Impact of Housing on Real GDP Growth via Residential Investment and Housing Wealth/MEW [9]



economist at Ameriprise Financial, estimated that a rebound in homebuilding, after a six-year slump, would generate as many as 500,000 jobs in 2013 and 700,000 in 2014.[8] In other words, housing is not just housing; it's a big deal.

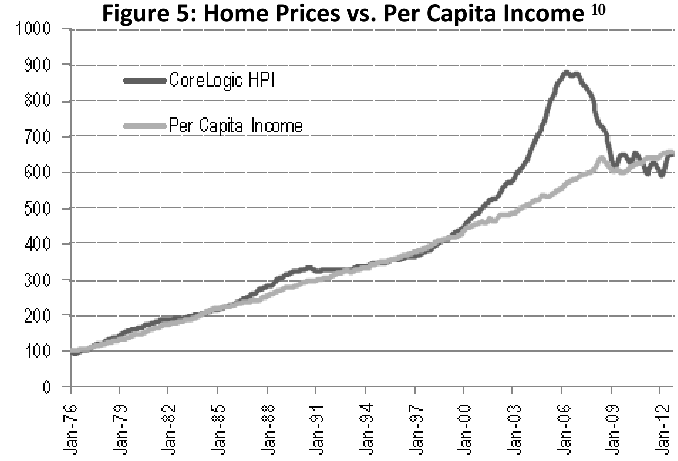
Is this rally real and sustainable?

If there is a lesson to be learned from the recent financial crisis, it is that one should always temper exuberance with rationality. With that said, the pick-up in housing should be both a cause for celebration and alarm. Every single reason for the resurgence in housing cited above is more of a short-term catalyst than a long-term, self-sustaining change. On the Federal level, the fact remains that housing is being indirectly subsidized through government programs and artificially low interest rates. And even more, with Fannie Mae and Freddie Mac now purchasing approximately 90% of all mortgages, one could argue that there has been a direct subsidy, as well. Switching back over to the organic factors, ultimately the pent-up household formation will work its way through the bottleneck, investor purchases will subside as housing returns to a more a more normalized cycle, and real supply will bridge the gap with demand.

So is the rally real? Yes and no. The housing market has stabilized and prices have been increasing; these are indisputable facts. Still, it has had a lot of help. As an illustrative example, think of a child learning to ride a bicycle with the training wheels on. There is a point where if the training wheels come off, the child will fall. The child is technically riding the bike, but not really. There is also a point, however, where even with the training wheels on, the child is really, truly riding the bike on their own, and if the wheels were to come off, the child wouldn't fall. With housing, the training wheels are undeniably still on. Even so, it's probably a little too early to say it is riding on its own. It still feels a little more 'technically-real' than 'real-real'.

That is not to say, however, that the housing resurgence doesn't have the potential to become 'real-real'. Despite the short-term nature of many current catalysts and the existence of headwinds like higher credit standards and lower savings rates, there have been some very encouraging signs that point to real sustainability. For example, there has historically been a direct relationship between housing prices and per capita income. From 1960 through 2000, the two tracked one another lock-step. The trend was broken in 2000 as home prices took off, only to fall below the trend line in 2009 (see Figure 5). More recently, however, home prices have reverted back to that long-term trend line and the relationship has been restored. This renewed relationship suggests as long as interest rates remain fairly tame and employment continues to firm, the housing market is likely to remain intact.

Figure 5: Home Prices vs. Per Capita Income [10]



Source: J.P. Morgan, CoreLogic, U.S. Bureau of Labor Statistics

Also encouraging is that fact that housing has plenty of room to run. As is shown in Figure 4 above, residential housing as a % of GDP has a long way to go until it returns to its pre-crisis or long-term average. In fact, despite a 30% rise in softwood lumber, an 80% increase in OSB prices, and a 26% rise in gypsum prices since the beginning of 2012, overall housing prices are still roughly at 2004 levels.[11] And although people often forget it and assume prices go up infinitum, housing is a cyclical business. As we emerge from a trough, there ought to be some supportive cyclical factors at play, as well.

Conclusion

Here at Doucet Asset Management, the resurgence of the housing market has greatly benefited client portfolios and model strategies, alike. Non-Agency Mortgage Backed Securities that were bought in the trough of the housing cycle have been sold on the upswing to the tune of double-digit gains in many cases. Cash (both from existing cash balances and sale proceeds) has been re-deployed into very conservative, short municipal bonds as a cash alternative. Other funds have flowed into certain income-producing equities and smaller micro-cap names. Looking ahead, we expect inefficient stock pockets to arise and market hiccups to happen along the way. As such, we do advocate maintaining sufficient cash balances to take advantage of opportunities like this as they pop up. On the bond side, we continue to seek out yield in a yieldless market. Finding it often entails buying small, scrappy pieces and sometimes feels like Yeomen's work. And while we do not think yields are going up overnight, it is our intent to maintain short portfolio durations in an effort to limit interest rate risk, and to seek out a cocktail blend of securities that should perform well when they do.

If this is a Harry Houdini economy, then the Fed is the old Master of Illusion himself. Although the optics of the housing market have been good, it is important to remember that things aren't always as they seem. While it is too early to tell if the revival of the housing market has just been one big economic sleight of hand, it is nonetheless a very positive development. And in a globalized marketplace where Cyprus and its 1.1 million inhabitants can roil worldwide markets, it has been a welcome one, at that. Still, we are not out of the woods just yet, and one would be wise not to get too caught up in the numbers alone.

Sincerely,

Chris L. Doucet
Chief Executive Officer

Footnotes

1 Leah Schnurr, "Location Crucial for the U.S. Housing Recovery", Reuters, March 26, 2013

2 Joe Weisenthal and Mamta Badkar, "Chart of the Day: That's What a Housing Recovery Looks Like", Business Insider, March 26, 2013

3 Michael Cudzil and Daniel H. Hyman, "The U.S. Housing Market's Road to Recovery: Slower Speed Limits and Stricter Enforcement", Pimco Viewpoints, April 2013

4 Nick Timiraos, "Housing Prices Are on a Tear, Thanks to the Fed", The Wall Street Journal (wsj.com), April 7, 2013

5 Bernice Napach, "This Housing Recovery Is Different: Investors Are Now Big Buyers", Yahoo! Finance, March 25, 2013

6 U.S. Bureau of Economic Analysis

7 Gary D. Burnison, "The New Normal?: GDP and Housing Up, Job Growth Tamped Down", Yahoo! Finance, April 22, 2013

8 Steve Matthews, "Housing Juggernaut Seen Spurring 500,000 New U.S. Workers", Bloomberg, April 11, 2013

9 "Housing & GDP: From Headwind to Tailwind", Goldman Sachs via thebasispoint.com, October 22, 2012

10 *US Fixed Income Markets 2013 Outlook*, J.P. Morgan, November 21, 2012

11 *Eye on the Economy,* National Association of Home Builders, March 28, 2013

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.