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Note

BURNEY COMPANY
INVESTMENT MANAGEMENT

Housing and the Recession

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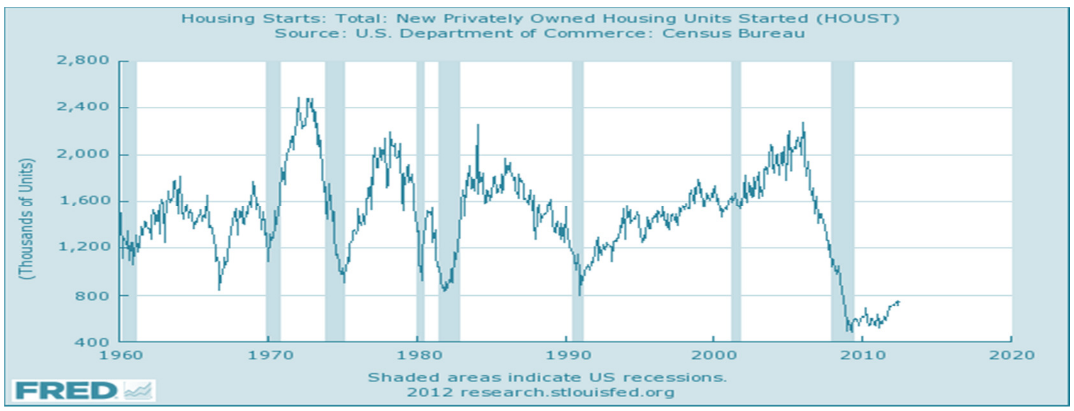
The Great Recession officially started in December 2007 and ended in June 2009. So why, in 2012, are we still faced with 8% unemployment, tepid job growth, and an enduring recovery? And when will we be able to say we are no longer "recovering" but "recovered" from the crisis? The answer lies in housing. Housing starts – and more specifically, the change in housing starts - are the best forward-looking indicator for the economic cycle. Recently, housing starts have picked up and the banking and consumer sectors have noticed. We may be seeing the early signs of a substantial and earnest recovery.



Housing has been the missing linchpin, and as it continues to improve, so will the economy.

Since World War II, the U.S. has experienced 11 recessions. Nine of those were directly preceded by substantial problems in housing and consumer durables (the other two were extraordinary events, the Korean War in 1953 and the Dot Com Bubble in 2001). While the most recent recession was one of the most severe to date and is widely known as the "Financial Crisis", it was brought on the same way as previous recessions[1]. Take a look at the chart above and the pattern is obvious. A fall in housing starts precedes a recession. Housing starts bottom out, and then rise on the tail end dragging the economy out of crisis. Housing starts were falling well before the 2008 recession began but did not immediately rise on the tail end, hence no substantial recovery ensued. The recent uptick may be the beginning of a rise that kicks the recovery into gear. And that's not the only measure pointing to a housing recovery.

Home prices rose this summer as indicated by the latest S&P/Case-Shiller 20-city index. More importantly, distressed sales – mostly foreclosures and short sales – fell. Historically, distressed homes account for only 5% of all home sales. During the current recession, distressed sales reached 50% and sold at a 25% to 30% discount to comparable, non-distressed homes. As of May 2012, the number of distressed sales fell to around 25% and the discount fell to 20%. Because banks stand to lose on foreclosures and short sales, this should be good news for them.

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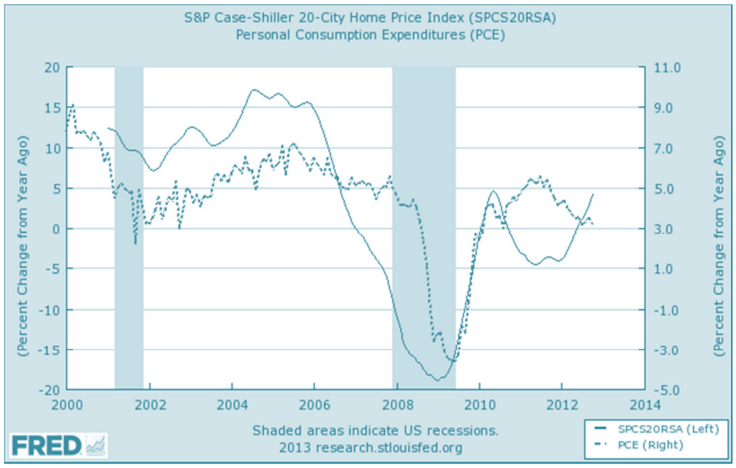
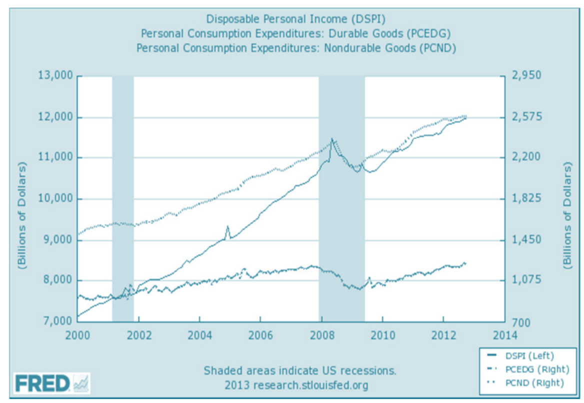
1 *National Bureau of Economic Research scholar James H. Stock: "Disentangling the Channels of the 2007-2009 Recession".*

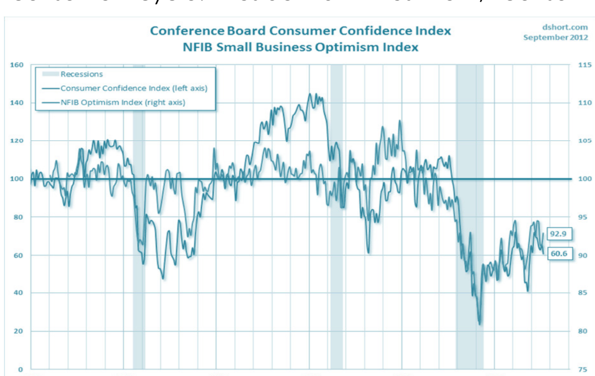


It is. Banks are losing less money on distressed sales. Second quarter bank earnings were up 21%. The number of troubled banks fell for the fifth straight quarter. So far this year 40 banks have failed, far below the 92 banks that shuttered last year and the 157 that closed in 2010 — the most for one year since 1992. Banks also became less cautious about lending. Loans to consumers increased even in places that saw first quarter declines like credit card loans and home mortgages. Less cautious banks means more loans which means more people buying houses.



Since housing is a consumer's largest asset and accounts for 70% of total private sector debt, it has a huge impact on the psyche of consumers. As a result, real estate prices and consumer spending are closely linked through consumer net wealth. In other words, when home prices are high, consumers feel wealthier. When consumers have more wealth, they spend that extra wealth. As shown in the following chart, change in consumer spending (red) closely tracks change in home prices (blue). We are currently experiencing a rise in home prices, which means consumer expenditures should be on their way.

This is important because the economic cycle in the U.S. is not a 'business' cycle but rather a consumer cycle. Residential investment, consumer services, consumer nondurables and consumer durables together make up over 70% of GDP growth. Business spending on equipment and software, structures, and inventories, on the other hand, do not contribute in as significant way[2]. Since the end of the Recession, disposable personal income and consumer durables/nondurables have been steadily rising. Consumer confidence is a little more volatile but has also been trending upwards.



An abrupt and decisive recovery is probably not realistic as gains continue to fluctuate and grow at a sluggish pace. However, the positive signs out of the housing market backed up by comebacks in the banking and consumer sectors are classic indicators of a strong recovery ahead. Housing has been the missing linchpin, and as it continues to improve, so will the economy.

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2 National Bureau of Economic Research scholar Edward Leamer: "Housing is the Business Cycle".