THE PARLIMENT PAGES

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HOUSING RECOVERY, BUBBLE OR CRASH? -

That is the question and the more you read, the more you see differing and contrasting opinions. Never before have we seen such a divergence combined with such extremes. Let's explore what each position expounds.

RECOVERY -

Even though the sale of new homes has tumbled the last couple of months, the homebuilders view that as optimistic. Their thinking is that the sales tumbled because there was not enough inventory to meet demand. If there had been more inventory on hand, sales would have been much higher. Therefore, they believe, you need to ignore the recent statistics on sales. While there is some logic to this, I believe it is dangerous to base conclusions on this type of thinking.

However, many of the basic fundamentals of housing do point in a strong direction. Household formations rose in 2013 to 980,000 from the previously depressed numbers of around 400,000. Even the 980,000 is well below the long-term average of 1.2 million. We have always been a believer that household formations was one of the most important key indicators of potential demand. Logic would dictate that a household formation needs to live somewhere. The rate of home ownership has dropped to the lowest level in recent history, as more and more formations are moving into multi-family apartments. However, even with the increase in apartment living that still leaves enough formations that are going the single-family route. If we continue to increase formations to the historic levels, that should deliver even more positive growth.

The number of homes in foreclosure in our market area has also decreased from the exceptionally high number of 31% to a little less than 20%. While that is still one in five, the foreclosures seem to be having less of a competitive impact as the remaining foreclosed homes are mostly either in geographically undesirable locations or the properties have been so run down they are not viewed as competitive to a new home. While the inventory of foreclosures is still quite high, there are not a lot of new foreclosures taking place. Most of that has happened.

In the last couple of months, housing starts have dropped from an annualized 900,000 number to a little over 400,000. The recovery guys say that is not to be considered as most of that decrease was weather related. If you look at the winter we had, it is hard to argue with that thinking as long as the next couple of months see the starts number getting back to the 900,000 number. This should be watched closely.

BUBBLE -

Many pundits today are saying we are in another housing bubble. Anytime a bubble appears, the question is always, "will it get bigger and when will it burst?" The proponents of the bubble condition believe we are on the front edges of the bubble and that it will be quite some time before we are faced with it bursting. The primary indicator for the bubble is the increasing home values and the unfilled demand that the builders are seeing. In addition, there are still a large number of homes being purchased for cash. At last count about 23% of all home purchases were cash and the presumption is that these buyers are investors. Investors typically don't buy unless they believe there is still price

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appreciation on the horizon. You may recall it was the incredible price appreciation of the mid 2000s that created the last bubble. This leads the advocates of the bubble to claim that there is substantial room for price increases which in turn will lead to a heated-up market.

CRASH –

Those that believe we are in the first stages of a crash are ironically utilizing much of the same statistics of the recovery as the bubble folks. They just interpret it somewhat differently. In addition, they look at a different set of facts that supports their contention. One of their primary indicators is the mortgage application rate. This number has consistently been running around 20% less than the previous 12-month period. I think the question here is what drives a mortgage application. If people apply for a mortgage prior to buying a house and that number is decreasing, I would find that a number of concern. However, if the mortgage applications are coming after a house is contracted, it would only support the recovery people who are claiming sales are down because of inventory and weather.

The crash enthusiasts also lay much of the strength of their claim on the cash buyer. At one point, just a few months ago, the number of cash buyers was actually close to 40%. Most of those buyers were the big hedge funds and institutional buyers. One large well-known hedge fund bought over 30,000 homes in Florida alone. These large buyers have disappeared from the market. The crash proponents believe that the “smart money” has left the market because of a fear of a crash in prices. They believe the cash buyers today are the small investors who typically follow a trade and end up losing as so many did in the last crash.

CONCLUSION –

I could go on for pages and pages giving the argument for each of these positions. What I have found is that if you only read one source, you will quickly believe that source because the arguments can be so compelling.

We use multiple and conflicting sources as our research to try to get a real balanced view. In the end, the consistency that we see is the analysts see housing as part of the big picture moving in sync with the overall economy. Those that believe we are in a housing recovery also believe we are in general economic recovery. Those that believe we are in a bubble believe that we are headed upward with plenty of growth ahead. And those that believe we are in a crash, think a major recession is right around the corner.

This level of divergence in itself is a major cause of concern. How can any business make plans when there is absolutely no agreement on what the future may look like? It is this uncertainty, which is causing much headwinds for a real recovery. And this uncertainty comes from so many different sources. First, as seen above, the “experts” can’t seem to agree on anything. Next, the numbers that come out of the government are continually being revised and calculated in differing manners to drive specific political agendas. And finally, the Federal Reserve Bank refuses to give any opinion on the future and instead continually leaves their position up in the air. Will interest rates go up? Will the Fed stop buying bonds? Will the Fed stop injecting capital into the banking system? When asked these questions, the Fed consistently answers by saying they have no firm determination on any of these.

Strategists sitting in the corporate offices or small business owners trying to make next week’s payroll don’t know whether to plan for expansion or contraction. They don’t know if the cost of capital is going up or staying the same. They have no clue as to whether wages will rise or whether we will be hit with high levels of inflation. They fear increasing levels of taxation and regulation and have lost confidence in the voting public to elect responsible politicians. This is what has cast the light of uncertainty over our economy in general and housing in particular.

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We think this condition will result in a neutral position where we limp along at the present rate. Overall economic growth will be in the 2.5% range, housing will continue to bump along at about 800,000 annual starts, unemployment will remain high, wage growth will continue to stagnate and we will see selective inflation in many items of necessity. Taxation will dramatically increase as regulation drains further resources. We are moving away from the concept of a free-market and instead are rapidly taking on a socialist persona. History has consistently shown that socialism does not produce growth.

CHINA –

There is one thing that many of the experts agree upon. China is on the brink of a huge economic problem. There appears to be total consensus that something bad will happen across the pond. It is only a question of how bad and what the international repercussions might be.

As most of you know, China has experienced over 10 years of phenomenal growth. Most of those years saw double-digit growth with some years hitting as high as 17%. (Keep in mind that we are growing at annual rate of 2.3%) Unlike the United States where most of our growth comes from consumer spending, the growth in China was driven primarily by government spending, funded by the huge dollar reserves China held. Over 70% of the U.S. economy is consumer driven while it is only about 40% of the Chinese economy. With this type of imbalance, it is easy to get upside down real quick.

Just in the past month there have been several indicators of some major problems. For the first time, China is letting large financial institutions fail and/or default on obligations. While this is a positive sign for free market economics, China has not been a free market economy. Since they operated outside the rules of a free market, wild government sponsored speculation took place, exorbitant government projects were built, and unprofitable companies were propped up by central bank subsidies.

These manipulations have led to numerous bubbles. One of the biggest is a housing bubble that will likely crash at any day. Home prices have skyrocketed and demand has slowed to a crawl. Many of the newly minted wealthy Chinese are moving capital out of the country. Consumer spending has not improved and the factories that drove much of the previous growth are stagnating as the world economy slowly recovers.

There just is no doubt that we will see a major situation come out of China in the near future. The only question is the impact it will have on our economy and the housing industry on our shores. We believe that the decrease in spending will create a surplus of factory capacity. While some of that capacity will be shuttered up, the remaining capacity will be driven to lower prices. (supply/demand) These lower prices will likely impact the imports of building supplies that flow quite regularly to the U.S. As a result, we will be keeping our eyes on pricing and will not be surprised if this has a stabilizing or even deflationary impact on some building materials. We will keep you posted as this situation further develops.

HOW TO REALLY CAPTURE YOUR CUSTOMER'S BUSINESS –

I recently read one of the best sales books that I have ever read. One of the impressive things about this book was the research that went behind the content. This was not just the opinion of some sales guru, but instead was a series of findings based upon extensive and broad-based research. In particular, it looked at buying motives such as value, price, and ease of business, personal relationships and many others.

The eye-popping result was that 57% of the buying decision was not based upon product but rather the actual buying experience itself. This really began to make sense when you consider that there really is

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so little perceived differentiation in products today. Most customers cannot tell one product from another and most companies provide similar service levels. Instead the major factor driving a buying decision was the value delivered in the sales call by the salesman.

The value of the sales call was defined as helping the customer's business become more profitable. In today's market where pricing differentials are in pennies, the customers need far more than pricing to have significant profit impacts. As a result, the book suggests that you look at your sales calls and ask if you are really delivering significant value during that time in front of the customer.

The book made me think of four values that every customer should receive. The first is speed. Time to market has become critical in today's age of everything right now. Technology and competition has made us a very impatient society. As a result we have come to expect "immediate" on everything we do. Since we are in the distribution business, that means we have to manage the flow of goods to that definition. It requires front line service and delivery capabilities. It means better inventory levels. It means quicker lead-time on purchases. And it means quicker resolution of problems.

The second value is your enhancement of your customer's brand and reputation. Your customer is selling his services and like yourself, 57% of his success comes from the selling experience he delivers. Do you understand your customer's brand and what you can do to help him consistently deliver that brand? If you query your sales people, I think you will be shocked to hear that they don't have a clue what their customer's brand might be and whether or not they have attempted to even sell to that point.

Third on the list of values is probably the most difficult of all. It is difficult because it requires the substantial investment of time on your part, your salesperson's part and the customer as well. That value is delivering expertise and innovation. To really accomplish that, you must spend an inordinate amount of time searching out innovation and training your sales people on how that innovation can be used by their customers. Whether it is a new method of application, a new product or a new material, you must be continually on the lookout for change. Once you have that innovation, your salespeople must take their time out of "order writing" and they, in turn, must educate the customers on the benefits of this innovative solution. And lastly, and probably, the most difficult, the customer must see you as a trusted industry expert who brings value to the table. As such, they must be willing to spend the time with your salespeople to allow this innovative education process to take place.

The final value is how easy are you to do business with? One of my favorite exercises is to identify all of the customer touch points in your organization. Most leaders believe there are just a couple. However, when you do a true deep dive, you will find scores of interactions with your customers. Are those touch points consistent with your brand? Are each of those touch points designed and monitored to insure the ease with which your customer does business with you? You can have a great sales person conducting a great sales call, only to have the entire experience fail because of improper or complicated invoicing. You can do a great takeoff and offer some profitable value engineering only to have it all go for naught because the shipped goods were defective, packed incorrectly, or delivered by a surly driver.

In order to execute these four values, you must also understand the reality of the market. There are some customers who just will not appreciate your brand. Fortunately research is starting to prove that those that don't appreciate these four values will struggle to maintain viability in today's market. Don't be afraid of casting those customers aside, instead, focus your efforts on those that appreciate who you are and what you can deliver in the selling experience.

I urge you to look at these four values. If you can successfully execute on all four, you will gain a competitive advantage. With that competitive advantage, you will find that pricing is not the central issue and as a result you will see your profits rise.