THE PARLIMENT PAGES

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INTEREST RATES – PART 1 –

In the past month or so there has been a lot written about the effect of interest rates on the housing industry. This is a subject much more complex than just what is happening to mortgage rates. The impact carries both short and long term ramifications with corresponding relationships for the economy as a whole.

INTEREST RATES – PART 2 - HOW THEY ARE DETERMINED -

Interest rates have traditionally followed the basic economic rule of supply and demand. When the amount of capital available is fixed and demand for that capital rises, interest rates will also rise. When there is a surplus of capital, rates charged will decline. If we operated in a true free market economy, that premise would always rule.

Short-term rates operate largely outside of governmental influence. One of the most common known standards of short-term rates is LIBOR (which stands for London Interbank Overnight Rate). This is the rate that banks will agree to pay each other on short-term settlement contracts. It is very much driven by supply and demand economics.

The bond market generally drives long-term rates. The bond market is a large and complex market trading everything from high grade Corporate Bonds, to Junk Bonds, to Governmental Treasury Securities. Most bonds will carry a fixed interest rate, however the bond will trade at a premium or a discount based upon how the prevailing and future rate expectations compare to the stated rate on the bond.

INTEREST RATES – PART 3 – MORTGAGE RATES –

Most mortgages are closed by a lender who will then subsequently package a large number of them together. Once that “portfolio” has been amassed, the entire portfolio will be sold to an investor. That investor may be another bank, an investment fund or one of the Government sponsored agencies. The purchasers of these portfolios will estimate future rates, payoff terms, and credit risk and will assess a value to the portfolio that includes a return on their investment. Knowing that they must price their portfolio to sell, the closing lenders will establish a mortgage rate that ensures they can sell the portfolio and still make a little money.

INTEREST RATES – PART 4 – HERE COMES THE GOVERNMENT -

What has been described is the scenario that operates under a free market economy. However, we do not operate in that free market economy. Instead, the Government has decided to manipulate interest rates using the Federal Reserve Bank as the tool.

The Federal Reserve has expanded its balance sheet by almost $3 trillion dollars in the past 4 years. In common terms, this expansion has taken place by the Fed artificially “creating money.” They are creating this money to subsidize the Federal Government’s deficit.

Every month, the Federal Government’s Treasury Department will calculate how much money they need to cover the checks they will write. To cover this shortfall, the Treasury Department will conduct

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a monthly auction offering Treasury Bonds. Anyone can participate in purchasing these bonds. Some of the purchasers are foreign investors, both governmental and private. Some are private U.S. citizens who are buying direct or maybe through their retirement plans. One of the major purchasers are the domestic banks who are buying bonds to put idle funds to work. The number of buyers and their appetite will determine the rate that the bonds will sell for. Obviously, if few buyers appear, the bonds will have to carry a highly attractive interest rate to attract more buyers into the room.

The Treasury presently cannot afford to have rates rise. First, there is the concern that high rates will create a bigger drag on the economic recovery. Secondly, the higher rate will result in more expensive loans which further increase the deficit which in turn puts even more upward pressure on future rates.

To fix this dilemma, the Treasury calls their buddies at the Federal Reserve Bank and asks them to show up at the auction. They are told to bring their checkbook and aggressively buy the bonds, thereby driving the interest rates lower. Currently, the Fed is purchasing about $85 billion of bonds each month at auction. Remember, the Federal Reserve checkbook is unlike any checkbook that you or I have. The Fed checkbook has unlimited amounts of money available. They can buy whatever amount of bonds they would like because they just print their own money.

INTEREST RATES – PART 5 – WHAT WILL BE THE IMPACT ON MORTGAGE RATES? –

The involvement of the Federal Reserve Bank manipulating the economy is historic. Their involvement has clearly taken away market forces in the determination of interest rates. In an attempt to lessen their control, there has been much talk over the past month about whether the Fed would "taper" their bond purchases and allow market forces to once again come into play. However, the Fed is in a particularly difficult position. If they cut back on their purchases, interest rates will likely increase, the economy will slow and the stock market may crash. If they continue their unlimited purchases, most economists believe this will ultimately result in inflation. As inflation is a problem "down the road," it is a secondary problem at this time. Therefore, the Fed sees little risk in continuing their purchases and will continue to do so for quite some time.

Our bet is that they will enter into a gradual and nominal cutback of purchases sometime in the first quarter of 2014. Such action will have a small impact on mortgage rates. As a result, long-term bond rates and the corresponding mortgage rates will probably increase somewhere between another ½% - 1% between now and the end the first quarter of 2014.

HOW WILL THIS IMPACT HOUSING STARTS? –

Over the past couple of months there has been a tremendous amount of press surrounding the impact of rates on housing. It is really important to drown out all of the noise and really focus instead on the fundamentals. Over a 60-day period annualized housing starts went from 318,000 to 945,000 and then back down to 412,000. These numbers are crazy and are not indicative of anything other than wide fluctuations brought about by short-term transactions. In the end, we believe any increase in interest rates will not be significant enough to change our projections that we made at the beginning of the year. We still believe annualized housing starts will be in the range of 900,000 by the end of the year.

OTHER IMPACTS OF THE MANIPULATED RATES –

In the past 18 months, hedge funds have become major purchasers of real estate. Their particular target has been the high-grade foreclosed product. One of the prominent hedge funds is the well known Blackrock. They recently completed their 30,000th single-family purchase. Within the past few weeks, they announced they were no longer buyers in that market. They believe the prices are no longer bargains and that increased interest rates will make these acquisitions less economically feasible.

Since most of their purchases were not new homes, their exit will not have a direct impact on new construction. However, as these hedge funds do turn away from housing, demand will slow and houses will turn more slowly. We do not believe this will affect new construction. However, this will have a negative impact on the valuations that have seen steady increases over the past few quarters.

HOME FORMATIONS –

We believe one of the more important indicators of a housing recovery is the number of home formations. At the peak in 2006, home formations hit a high of 1.3 million. As the crash took firm hold, that number dropped to less than 500,000. It has been steadily rising over the past couple of years and now rests at 980,000. Ironically, this is very close to the number we had projected for housing starts. The relationship between formations and housing starts has not held in the past because the vast number of formations went to rental properties. While rental properties continue to show improvement, there is some indication that single-family ownership percentages may be on the rise as well.

BUILDING PRODUCT PRICING –

We continue to see stabilization in most pricing. In the past issues we expressed concern that the pace of the recovery might outstrip the ability to produce. We still believe that is a threat that could hit sometime over the next 6 months. The fundamental problem still exists. There simply is not enough manufacturing capacity to meet the projected number of housing starts. Stay tuned.

BRANDING –

Commoditization has hit virtually every part of our society. Almost any product or service continues to come under immense price pressures. Differentiation between products has increasingly become more difficult as “copy-cat” competitors arrive every day. Excluding technology, it is just becoming harder and harder to sell differentiation.

With this as our economic backdrop, it becomes apparent that it is important to increase the value of your company brand. Savvy leaders are questioning what they are doing to truly identify their brand and then communicate that brand message to their customers.

What is a brand? It is simply the mental impression that one gets when he/she sees or hears your Company name. The principles of brand management are quite simple:

- Identify your targeted audience
- Develop a brand message
- Execute on the brand message

The stronger your brand, the better your defense against the increase in commoditization. As you become more aware of your brand and the power it can hold, you may also find an intersection with your customers. Ask yourself if you are contributing to your customer’s brand strength. This is an interesting discussion that can lead to a much stronger relationship between you and your best customers.

DO YOU SAVE YOUR CUSTOMERS TIME AND MONEY? –

Commoditization will typically result in lower gross margins. Lower gross margins mean there is less money to spend on the core expenses of a company. One of the best ways to deal with commoditization is to show your customers that you can help them reduce their core expenses. Look

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carefully at how you deliver your product and service to your customer. Are you able to reduce his core expenses and are you properly communicating that savings to him? Does he understand the impact of that reduction and how that just may be the differentiator that will cause him to do more business with you?

SEGMENTING CUSTOMER BASE –

Let's face the reality of selling in today's market. Every customer has different needs. Some will need little from you other than promised service. Others will need handholding and special attention. Some require a real partnership relationship while others will never see you as anything more than a replaceable vendor. Understanding this segmentation is important in the development of your customer strategies. We have always segmented our customers and vendors by slicing and dicing in multiple formats. We look at overall account profitability. We rank by total gross profit dollars. We estimate future growth opportunities. We rank them on ease of doing business with. And finally, we rank them on how we can become valuable to them.

Every company has limited resources. Sales people can only make a certain number of calls each day. Deliveries can become unprofitable for numerous reasons. Specification work can drain resources. Slow paying customers can limit capital. Research can take time away from more productive activities. Aligning your expenditure of resources with the segmentation of your customer base is an important and profitable account strategy. Take some time and create those segmentations and then analyze whether your deployment of resources makes sense.

BUSINESS PLANNING –

We are once again entering the time of the year when many of us will start thinking about our annual business plan for 2014. We are often asked what is a business plan. A business plan is a document that sets forth the actions necessary to achieve the desired future results. It can encompass a sales plan, a marketing plan and a budget. However, to be truly effective a plan should meet the following criteria:

- No longer than one page. A one-page plan allows the following:
    - Something that can be easily communicated to the entire organization
    - Clear focus
    - Prioritization of needs
- Dynamic. Circumstances are continually changing. Plans that are made in December can easily be irrelevant by October. Business just moves too fast. A plan must have the flexibility to change as is necessary
- Easy to articulate. Everyone in the Company should understand the focus and the priorities. The better the level of understanding, the more likely execution of the plan will take place. Nothing is better for understanding than simplicity
- A disciplined implementation and execution process. This is clearly the most important aspect of any business plan. Business plans do not implement themselves. It is critical that the plan be reduced to actionable items with appropriate accountabilities assigned and reported. We believe implementation results should be reviewed on a monthly basis. We further believe the plan should be reviewed quarterly and adjusted to meet current relevancy.

Business planning is a mysterious and frightening exercise for most executives. And yet the benefits of a well-developed and well-executed plan can yield remarkable returns. Not only will your business profit, you will also begin the long process of developing a team and the discipline of accountability. However, the biggest benefit of planning will come from the confidence of your employees when they see a leadership group develop and execute a plan year after year.

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