THE PARLIMENT PAGES

JULY, 2015

MAYBE WE ARE GETTING SOME CLARITY –

We led off last quarter's newsletter with the banner headline of "What a Confusing Mess." We discussed the apparent disconnect between what we see and what we read. We now see a lot of promising indicators. New developments are shooting up. Infrastructure construction is underway. Contractors are showing more optimism and higher risk tolerances. And yet against this backdrop, we saw hard and fast economic indicators that just didn't support much optimism.

Well finally, the economic indicators are starting to line up with our intuitive observations. While there are still a couple of headwinds that are undoubtedly slowing things down, the overall momentum is positive.

LET'S RECAP SOME OF THE REPORTS –

Housing starts continue to bounce all over the board. There was a 22% jump in the month of April that was followed by an 11% drop in May. With May traditionally being one of "up" months, there was some disheartened interpretation of this drop. However, even with the drop in May, we still are 7% over where we were a year ago. In addition, the surge in multi-family seems to have slowed while the single family numbers are picking up some steam.

However, let's look at this from a broader picture. In May 2011 the number of single-family starts was 414,000. Since then the May numbers have climbed steadily reporting 518,000, 602,000, 637,000 and now 680,000. While this is nowhere near the heady days of 2005 when 1.57 million starts took place, at least it is a steady and consistent growth pattern.

Even though starts did decrease in May, building permits increased by 11.8% to 1.275 million units. Keep in mind this number also includes multi-family. Permits are never as good of an indicator as actual starts especially this time of year when so many permits are driven by special tax considerations. However, this is still a favorable addition to the probability of consistent future growth.

Coincidental with this rise in statistics, it should be no surprise that the National Association of Home Builders (NAHB) showed a dramatic uptick in builder confidence. This indicator has swayed up and down for several years. However, again, there is a certain consistency that is now tracking.

With confidence comes speculative construction. Historically, as inventories of spec houses increase, so go sales. The industry has been plagued for a number of years by the lack of new homes in inventory. This lack of inventory has led many to believe that sales were thwarted by the lack of selection.

Since much of the new home construction market is driven by buyers moving from an existing home to a new home, the rate of existing home sales has always been an important indicator. While the number of existing home sales is not spectacular, it did rise almost 6% from a year ago. However, even more significant is the rise in value. Home values are up almost 10% from May of 2014. That contributes two significant factors for new home sales. First, it gives people more money to spend, which traditionally leads to larger homes. And secondly, and most importantly, it builds optimism and hastens decision-making.

All in all, these important statistics are validating what we intuitively believed. At the beginning of the year, we predicted single family starts in the 550,000 – 600,000 range. Due to the normal seasonal slowdown that will hit in the fall, we believe 2015 will actually end up at 600,000 starts, at the high end of our prediction.

<u>WILL HIGHER INTEREST RATES IMPACT THE HOUSING MARKET?</u>

There has been considerable talk about the Federal Reserve increasing interest rates. All sorts of dire predictions of such an event have filled the press blotters. However, there are a couple of important things to understand before you draw any conclusions on this panicked behavior.

We must first assess what the real likelihood of an increase would be and how much that increase would amount to. The Federal Reserve was initially formed to be apolitical and totally independent from political pressure. Over the tenure of the past two chairpersons, it has become a political instrument of the White House. It has also aligned itself with the best interests of Wall Street and the big banks. Because of these connections, one must understand that the decisions the Federal Reserve makes are very much influenced politically and by Wall Street and not by sound economic principles.

As most of you are aware, the amount of debt that the United States owes is a truly horrifying amount. This amount is typically broken into two components. One is the easily defined amount of Government Bonds outstanding that must be repaid. This debt currently is in the $7 trillion range. The other measurement is the amount of the unfunded future debt that will occur. This number ranges from low estimates of $35 trillion to a high of $86 trillion. These are truly insurmountable numbers that no one has figured out how to deal with.

However, for now, let's look at the easily calculated Government Bond debt. That is real debt and there is no question that it accrues interest and must be paid at the time of the bond maturity. The average interest rate on that debt right now is about 2%. That is weighted average of all long and short-term debt. At 2% interest, the interest payments currently eat up 17% of the Federal Government budget.

There has been talk that the Federal Reserve needs to increase rates by as much as 2% to gain the economic equilibrium they are seeking. However, a 2% increase in interest rates will double the amount due from the Government to a whopping 34% of the budget. One in three dollars would go to paying interest only. Clearly, that is not a political option as such an increase would take away all entitlements, substantial parts of defense, and a good portion of the day-to-day operations of the bureaucracy.

For that reason, and that reason only, you will not see a major increase in interest rates. Will there be some increases? Absolutely! We believe that we may see a total of ½ of 1% increase that will be enacted sometime in late 2015 or more probably in 2016. That small increase has already been factored into the markets and mortgage rates were adjusted accordingly several months ago.

In short, rising interest rates will not happen to any degree that will impact the housing industry.

THE BIGGEST HEADWIND –

While the picture does look promising, it could look so much more positive if just one factor did not exist. We have had a significant shift in the demographics and living practices within this country. In 1960, over 75% of all adults were married. Today that number is less than 50%. There are a multitude of reasons for this decline, some of which are:

- The huge $2.2 trillion student loan debt overhanging so many young people. Over $40 billion per year is paid by the younger generation in interest and principal. Those funds could provide a lot of down payments and mortgage payments for new home construction.
- The mobility of the workforce and the fear of being tied down to a fixed piece of real estate.
- Remembrance of the real estate losses incurred by parents in the last recession.
- Societal acceptance of a single life style.
- The lack of stable job prospects. In fact, the unemployment rate for recent college graduates is 4% higher than the national average.
- Family sizes have decreased from an average of 3.75 to 2.54. This increases the likelihood of multi-family living where the traditional home and yard are not as important.
- The realization of the younger generation that taxes are going to increase and medical expenses are going to rise exponentially. This generation does not believe they will have discretionary income that previous generations had.
- Acceptance from this generation that social security will not provide their retirement and they must generate their savings and retirement plans. Some have estimated that this is taking over 10% of the already meager pay for this generation.

Besides these reasons, the sheer population numbers of each of the various generations from millennials to baby boomers do not put enough buyers in the market to create a substantial increase in household formations. This is bad news as it is estimated that every household formation creates about $175,000 in economic boost. Since much of that amount is financed, that could create massive growth in the economy.

While we see this as a substantial headwind, this headwind has existed for the past couple of years. And yet, the industry is still growing. One can only wonder what the market would be like if this headwind did not exist.

INDUSTRY CONSOLIDATION –

In some of our previous issues, we have addressed the industry consolidation that we expected to take place. Well, it has hit with a fury. At the distributor level, Prime Source was recently acquired by Platinum Equity out of California. Platinum has a history of drastic expense reduction, pumping up earnings and then selling the company in a public offering. While we can't say that will happen with Prime Source, if it should, it will have a dramatic effect on the business model Prime Source has used for many years.

The sixth largest lumber dealer is Builders First Source. They recently announced the acquisition of fellow lumber dealer Pro Build. Interestingly, Pro build is the second largest lumber dealer in the nation. This is a case of the smaller swallowing the bigger. Choo Choo Builders Mart and Stock Lumber were recently acquired by BMC, another dealer who is owned by a private equity group. Private equity money is driving the acquisition train, as you can see.

These lumber dealer acquisitions seem to have a strong strategic component driving them. In almost all cases, there is little market overlap and the acquisitions seem to point to a strategy of gobbling up more geography.

We believe this is further evidence of optimism in the market and is an indicator that some big money believes the market is about to hit a strong growth spurt. While we can't go into any specifics, there are plenty of rumors of even more transactions will soon be consummated.

GREECE –

As we go to press, Greece is hanging on the precipice of default. An election is scheduled for July 4 that will contribute heavily to the decision-making. However, in the end the only question will be when Greece defaults. These are the options:

1. The elections favor the party that refuses to compromise and a default on the debt due happens immediately.
2. The bondholders of the Greek debt agree to write-off what is owed them.
3. A temporary band aid is put in place and the "can is kicked again down the road" as it has happened over the past several years.

However, in the end, there will either be a default or a write-off. The amounts involved are not that great. In fact, the entire Greek economy is just slightly larger than the economy of South Florida. However, the fear is that this could set the stage for other Euro Zone countries to also default. These countries are Spain and Italy who have much larger economies, which could cause severe ripple effect issues with the worldwide economy.

Markets are edgy and the speculation is high. Central banks have loaded up on so much debt and have thusly taken away their ability to actively fight a global economic meltdown.

Let's hope this passes quietly and calm heads prevail.

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