THE PARLIMENT PAGES

OCTOBER, 2015

WHERE DO WE STAND? -

Overall, there are a lot of good things happening. Existing home sales have been doing very well, up over 10% from a year ago. It is expected this number will continue to improve for the foreseeable future. However, as we dig deeper, you will see the news is even better. Last year, all-cash buyers, accounted for 32% of the sales. All-cash buyers are typically investors who can be real fickle when market conditions deteriorate. That percentage has dropped to 22% in the current year which portends a much more stable group of buyers. To confirm this, mortgage backed sales are up over 25% from previous years. Mortgages equate to homeowners as opposed to renters renting from investors. Again, this is a sign of stability.

Additionally, the average household is in the best financial shape of indebtedness in over a generation. Mortgages, car loans, credit cards and leases are all at a household low ratio. A high percentage of households with mortgages currently have the capacity to make these debt obligations. While there is still a lot of concern over the amount of discretionary income remaining, at least the threats of default have been greatly mitigated. Therefore it is no surprise that mortgage holders currently have the lowest levels of delinquency since 1992.

THE JOB MARKET -

Job stability is at one of its highest measurements in recent history. While new jobs added have continued to disappoint, jobs lost has consistently marched downward. Real income growth is non-existent, which has added a negative component to consumer confidence. However, while low consumer confidence hurts the economy overall, low confidence does tend to keep people in their existing jobs longer, again, thus adding to the stability.

HOUSING STARTS –

Starts continue on the pace of our predictions. However, again, there is an interesting statistic that comes from deeper analysis. Average square footage of starts is actually declining. Some may see this as bad news; however, industry experts believe this points to a growing demand for smaller homes, which typically are first time buyers. The reemergence of first time buyers is great news. These people have been gone far too long and when they enter the market, it starts the domino progression of people selling and moving up to larger homes. This “churning” has been missing from the market for several years. This is a significant development.

HOUSEHOLD FORMATIONS –

It’s estimated that every new household formed contributes $145,000 in new construction and furnishings, not to count the acceleration in spending after people have formed the household and/or gotten married.

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Unfortunately, household formations are not happening to level of predictions. In 1960, 72% of all adults were married. Today that number has dropped to 50%. Over the same period, the number of households has grown from 52 million to around 122 million, with the number of people per household falling 3.36 to 2.54. Rising households might *seem* like a good thing, but smaller households aren't as good for the economy as larger ones. This is a clear demographic and cultural concern that could have significant future ramifications on the housing industry.

Many of these factors are a normal result of an aging culture and economy. Fortunately, and unlike Japan, we are "aging" gracefully and we are keeping our economy functioning despite these changes. Overall, and despite many of the headwinds, growth in our industry continues, albeit at a moderate and sluggish pace.

AND THEN, IN STEPS THE GOVERNMENT –

There were a large number of contributing factors that led to our most recent economic crash. However, after extensive research and analysis, it has now become apparent that the single biggest reason for the collapse was the governmental mandate to banks to make substandard loans. This political decision filtered its way through the Federal Housing Administration (FHA) to its direct reports at Fannie Mae and Freddie Mac. They, in turn, literally forced mortgage companies and banks to accept substandard loans to be included in the "packages of loans" that were later sold to Fannie and Freddie. The eventual realization by the finance world that these packages consisted of large numbers of bad loans caused massive defaults and write-downs. These substandard loan policies were in place just 8 – 10 years ago, which is a period that should not escape memory.

Did we learn from the governmental influence? It appears the answer is no. The FHA recently sent out guidelines that Fannie and Freddie must buy loan packages in a certain mix of loans. Included in that package is the requirement that 24% of all loans must be made to families that earn 80% or less of the median income for their geographic area. In addition, they will no longer require 20% down payments but instead will accept down payment as low as 3.5%. Median income is $52,000 and 80% of that is $41,600. Therefore 24% of all mortgages bought by Fannie and Freddie must be to families with incomes of $41,600 or less.

Without boring you with the financial calculations, this level of income would typically support a principle mortgage payment of about $750 per month. At today's rates, a $750 monthly principle payment supports a mortgage of $157,000. Everything makes sense so far except here is the kicker. Fannie and Freddie have mandated that the income level of $41,600 should support a $240,000 mortgage and they will approve accordingly.

Do you see what is coming at us again? In well-intentioned fashion, the government has mandated that people be allowed to borrow more money than they can afford and more money than a normal underwriting process would approve.

While this may give our industry a brief boost, it is laying the seeds for another crash.

INTERNATIONALIZATION -

Big word that really describes the world we are living in and paying our bills. It has become impossible to really analyze the future of our businesses without examining the impact of world events. How different is this from just 20 years ago?

Just in our building supply industry, internationalization affects virtually every aspect. The most obvious is the huge amount of foreign manufactured products that end up on our shelves and in our yards. This foreign manufacturing has led to quality problems, packaging problems, product shortages and widely fluctuating prices. In some cases, international demand has even resulted in shortages and rationing of certain products. The increase in imported products has led to more government regulation, tariffs, duties and various protections. It is almost impossible to keep up with every mandate out of Washington that addresses our imported products.

Most of our business is driven by the demand in the residential housing markets. That demand has been influenced in the past years by an increasing number of foreign buyers. Whether they are buying on their own accord or are buying for investment purposes, their demand has had a noticeable effect on pricing and values of homes.

Where would we be today if interest rates over the past several years were not at historic lows? While our industry suffered, we could have literally disappeared if mortgage rates were in the normal range of 8% or higher. The finances of the international banking and economic communities have had a direct impact on our low rates. The economic shambles that exists in so much of the world has obscured our own precarious predicament. As a result, the US Dollar still remains the strongest currency around and, as such, does not demand high-risk interest on the sale of its bonds. Correspondingly, our rates continue to be well below the historic market.

Some of this internationalization will help us in the future and some may actually harm us. However, the important point is to pay attention because sometimes the most obscure article in the news could develop into a major factor in our business. With that being said, read on.

CHINA –

The best description of the Chinese economy right now would be that it is in the doldrums. Some are predicting much worse and believe a major collapse is in the making. These naysayers believe there will be a crash in Chinese real estate, increased loan defaults, and pressure on the currency. Irrefutable evidence is pointing in all of those directions. It is too early to tell which, if any, of these events will happen, but the results will be the “shot heard around the world.” Some of the results could be massive product dumping in the markets, panic selling of Chinese held US real estate, massive liquidation of US Dollars resulting in extreme currency pressure on our currency, and dislocation of economic factors such as shipping, natural resources and even manufacturing.

GREECE –

As we published in last quarter’s newsletter, the Greek question was in the headlines. Once again, the can was kicked down the road and disaster was averted. However, the basic problem still exists. That problem is that much of Europe, with the exception of Germany and Norway, are horribly in debt up to their ears. What is scary is that there are literally no positive signs that will bring the Euro group out of this fatal spin. The can can only be kicked so many times before there are no kicks left. While a collapse of the Euro countries would be bad, statistics show that would not be nearly as bad as a Chinese event.

BOTTOM LINE –

Specifically, we are seeing the increase of imported products. A couple of years ago, countervailing lawsuits attempted to control this dumping. However, it is uncertain what the legal positions will be if the dumping is caused by currency fluctuations instead of arbitrary pricing decisions. In the end, we believe the combination of worldwide economic conditions coupled with supply and demand will result in a continual erosion of pricing.

When prices head down, it is prudent to carefully watch your inventories and the quantities of your purchases.

Because of internationalization, we are not in control of the environment in which we must operate. Prudence dictates that we watch world events closely and understand the domino effect of some of these events and protect our businesses accordingly. Your Parliment sales people stay current on these events and will help guide you through some of your decisions.

MORE ON PRICING –

Across the board, there has been a gradual reduction in the cost of products. Therefore the profit dollars per unit also decrease. This is the time when it is crucial to reexamine your pricing to insure that your margin percentages are increasing enough to offset the dollar per unit decrease. Many businesses have failed to recognize this and have suffered greatly on their bottom line.

CONSOLIDATION UPDATE –

In every quarterly issue we seem to talk more and more about consolidation. In this issue, we are going to primarily address some of the consolidation that is happening in the distribution leg of our industry. Consolidation at the dealer level is continuing and we will address that in more detail next quarter.

Prime Source has always been one of the largest in building product distribution. Last quarter we wrote that there were rumors of a sale. Well, it did in fact happen and an investment company, Platinum Equity, did buy Prime Source. Shortly after the transaction, the co-CEOS of Prime Source were terminated and the new CEO is the former CEO of Blue Linx. Blue Linx is a publicly traded company that has not made a profit since 2006. There is a lot of supposition that one of the reasons for this shuffling is to position Prime Source to acquire Blue Linx. If this does happen, it will create chaos for both company’s customer base for quite some time.

We believe one of the most interesting aspects of this is the interest we are now seeing from outside investors in our market space. This interest, we hope, would be the result that big investment money believes we have a strong future ahead of us.

ON THE PRODUCT FRONT –

To help serve our customer base, we have recently added pre-cast concrete lintels. Many of our customers were having difficulty overcoming severe freight costs and by offering this product, we are able to help defray that cost and allow our customers to buy in more reasonable quantities.

We continually strive to have the right product mix so that we can be your one call supplier. Managing your inventory and purchases is one of the most important functions of a dealer. We currently have over 3500 products in our inventory and never hesitate to add more when it makes sense. If you would like us to look at something, please tell your Parliment salesman. The better our customers become, the better we become.