

INSIGHTS ON FRONT STREET



BY JASON P. TANK, CFA
FRONT STREET INVESTMENT MANAGEMENT LLC

THERE'S STILL NO PLACE LIKE HOME

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Back in June 2007, we wrote that before a bullish commentator uttered a word, they should be required to first take a simple oath. This oath began, "I solemnly swear that I believe, with all my heart, that the real estate recession has bottomed and that the consumer, whose spending is key to the health of our great nation's economy, will not miss a beat." And now, in July 2009, we believe that the latest wave of optimism oozing out of Wall Street should be prefaced similarly. Only, this time, they can replace "real estate recession" with "global recession."

Our economy still rests on the back of the consumer. In turn, their ability to spend still depends on the future path of home prices. We've been looking more deeply at the latest home price figures. The most widely followed index of home prices is the Case-Shiller Index and since its peak was set in June 2006, this index's measure of home prices has fallen a dramatic 33%. A national drop has only happened once before in our history.

This drop has not been uniform across the country. In cities across states such as California, Florida, Nevada and Arizona, home prices have fallen a dramatic 45% or more. In other cities, such as Dallas, Denver, Charlotte and Boston, prices have only come down 10%-20%.

Predictably, we've found that the factor that best explains the magnitude of the decline in home prices within each particular market was simply the scale of its preceding boom. The markets that experienced the astounding mid-teens annual growth rates have tended to fall

the hardest. The markets that exhibited more subdued growth during the bubble years, have correspondingly not fallen as far.

What we found interesting is that the level of unemployment, generally speaking, hasn't had as large an impact on home prices as one would expect. We aren't sure how long this phenomenon will last. Like a second wave, the deteriorating jobs picture could still more directly impact home prices.

Detroit illustrates our concern. In Detroit, while there was not much prior home price appreciation, prices have still managed to plummet 45% from their peak. This shows that at high levels of unemployment, things can fall even more than imagined. This appears equally true in bubble markets as it is in non-bubble markets. The worry is that prices could overshoot to the downside.

For this reason, in an effort to cut short a negative spiral, government policy has been

focused on protecting jobs at a considerable cost. While, thus far, homeowners have been quite reluctant to sell at ever lower prices, the evidence shows that high unemployment does eventually force their hand.

As a simple exercise, we decided to look at the level we would expect home prices to be today if the bubble had simply never occurred. Starting in 1995 or even 2000 (before things got really ridiculous), the data shows that if one were to assume that home prices just rose at the inflation rate, prices may still have another 10%-25% drop to go. This would bring the cumulative drop to a whopping 40%-45% nationally. Importantly, it would leave about 20 million homeowners owing more than their homes are worth. For everyone, it means they are less wealthy.

Attractive mortgage rates and enticing government incentives might limit the damage to the lower end of this 10%-25% range. However, it is also true that credit standards are much, much higher and, in aggregate, this might negate the cheap financing rate. Further, inventory levels remain abnormally high and many experts point to a large "shadow inventory" of troubled properties that have yet to come on the market. Given this, a 10%-25% additional drop from today's levels seems quite possible, if not probable.

Much rests on real estate prices not going down a lot more, let alone going back up again in the near future. Regretfully, our analysis of the home price data leads us to believe that prices are still falling. In our opinion, last year's big story, and its implications for consumers and the economic recovery, is likely to be this year's story as well.

We strongly feel this continued destruction of wealth will affect the consumer's ability and propensity to spend for quite a while to come. As we've stated a few too many times, consumers are deeply in debt, credit is tight, incomes are still under pressure as unemployment marches ever higher and overall wealth is shrinking. This is a potent cocktail and if these pressures are interpreted as semi-permanent by

consumers, they will keep pulling back to protect themselves.

To counteract the above issues, governments around the world are desperately trying to "prime the pump" by forcing down interest rates and spending money that doesn't really exist in hopes that the private sector gets its mojo back.

Government spending, the likes of which we've never seen (in peace-time), coupled with default rates and delinquency rates, the likes of which we've rarely ever seen, is giving the bond market heartburn. We are walking down a path that we've not really traveled before.

It's one thing to hold down short-term interest rates but it's quite another to hold down longer-term rates that tend to have a mind of their own. It is entirely possible that higher interest rates will choke off a recovery before it even begins. It seems correct to assume that extreme intervention will bring with it unintended consequences.

We feel compelled to counterweight this unusual economic climate with an investment stance that is equally unconventional. Our plan to remain hunkered down and focused on investing in stable and quality income for now is designed to let us exit this murky period intact. The patience required is not small, but the necessary protection it has provided has been considerable.

And, no matter how quickly we'd all like the (brighter) future to reveal itself, we know that, like most things in life, "tomorrow and tomorrow and tomorrow creeps in this petty pace from day to day." We're optimistically embracing this petty pace.



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