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When Will the Housing Market Bottom?

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By John Mauldin

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"When," I am asked frequently, "will we see a bottom in the housing market?" This week we look back at what past housing recessions have looked like to see if we can find a bottom anywhere soon. And could things be different this time? (Maybe.) We look at the government statistic on the number of houses for sale and find that it doesn't count all homes that are for sale. (I know it will shock most readers that government statistics might not be 100% accurate.)

All this and more, as we muse upon magazine covers and the markets and why the Irish can steal our hearts. It should make for an interesting letter, but first:

Just One Thing for Christmas

My most recent (and best-selling!) book, *Just One Thing*, is now out in paperback. It will make a great present for a friend or client, and works for both the seasoned professional and the new investor just starting out.

For those new to this letter, *Just One Thing* is my latest book and features the writing of 11 of my friends (and your humble analyst) writing about the one thing we have found most important in our careers. You won't find stock tips or the latest how-to turn a thousand into a million in five easy lessons, but you will get solid philosophical grounding on the basic principles of economics and investing from a group of really smart, successful guys (and then my musings as well).

I am proud of this book, gentle reader. There are 12 great chapters from some of the smartest minds I know (and me, of course, but the good news is that I get to be in their company, so I get to be smart by association). "Just One Thing," I told them. "Give me the One Best Idea you have learned about investing - the one thing you are personally most passionate about - that you want to pass on to your kids."

One of the great things about working in my world is that I get to run around with some very smart, very successful people, who also happen to be very good investors. I get to pick their brains and learn from the best. If you had a chance to sit down with Richard Russell or a Gartman or Kessler or Gilder (or Shilling or Arnott or the rest of the writers of my book) most of us would leap at it. What is one idea worth if it helps us become better investors, or saves us the pain of losses?

The authors of these chapters have all learned a lot along the way. "Why not," I thought, "ask them to share the wealth of their wisdom?" And so I did. The rules of the book were pretty few. I told them to write me a chapter on a subject they had expertise in and thought was one of the special insights they had picked up in their time. I gave them no minimum or maximum word length. Make the chapter long enough to cover the topic. As you will notice, some chapters are quite short and **others** are feature-length.

The reviews have been more than kind. You can get your copy at your local bookstore or go to Amazon at www.amazon.com.

Houses for Sale That Don't Exist in the Statistics

Lennar, the #3 homebuilding firm, said the cancellation rates for home sales were running about 30% last quarter. KB Homes said the number was 43%. A lot of anecdotal stories suggest the numbers could get worse. So that would add homes back into the Homes for Sale statistics that the Commerce Department (Census

Bureau) tracks, wouldn't it?

The simple answer is no. The Census Bureau surveys home builders and specific housing starts. If a home is built and at some point put under contract for sale, it is then considered sold. The Census Bureau does not go back a few months later and ask, "Did you really sell that house?"

Because of the way they do the survey, they do not double count if the home sells at some later point to another person. One house, one vote. In the long run, cancellations do not cause the system to either overestimate or underestimate the number of houses sold.

But in the short run? As their web site explains: "As a result of our methodology, if conditions are worsening in the marketplace and cancellations are high, sales would be temporarily overestimated."

So the recent data that shows new home sales as possibly, maybe, getting to a bottom of the cycle? With north of 30% cancellations, the number of actual sales is certainly less than the data is showing. (See more below on housing statistics.)

You can go to the following link at the Census Bureau to see the actual policy:
<http://www.census.gov/const/www/salecancellations.html>

When Will the Housing Market Bottom?

As part of my morning routine, I listen to CNBC as I get dressed and then on XM satellite radio on the drive in. Lately, after every bit of data on the housing market, there is at least one analyst who will proclaim the end of the housing recession. How long, I wondered, did it take for past housing market recessions to bottom, and how severe were they?

Thus I was delighted to get a recent letter from Hugh Moore of Guerite Advisors in South Carolina full of the answers to my questions. I always appreciate it when someone else does my homework for me. (A guerite, by the way, is a type of sentry box projecting out from a castle or fortress.) (www.guerite.com)

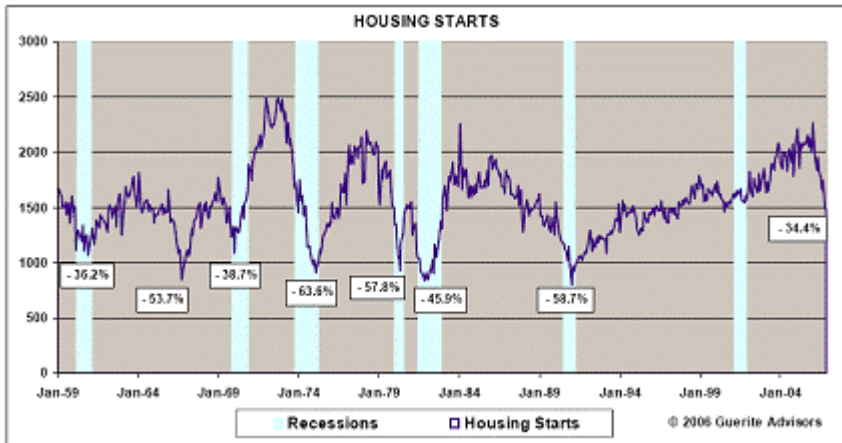
First of all, what we are really asking when we wonder about a housing bottom is, when is housing construction likely to turn back up? Today's rather bullish employment data does have one rather large negative. The construction industry has lost 53,000 jobs in just the last two months. That suggests it is not likely to bottom this year.

Sidebar: today's unemployment data was strong enough to push the yield on the 10-year back up by a large 7 basis points to 4.55%. It hit 4.40% last week. Bond traders will be wearing neck braces this weekend from the whiplash. The chance of a rate cut in March went down to 28%. I have been writing for a long time that the Fed is going to be on hold a lot longer than the market thinks. They are going to put a dagger in the heart of inflation. The question is will they be able to pull it out in time to help a softening economy. Now, back to the housing data.

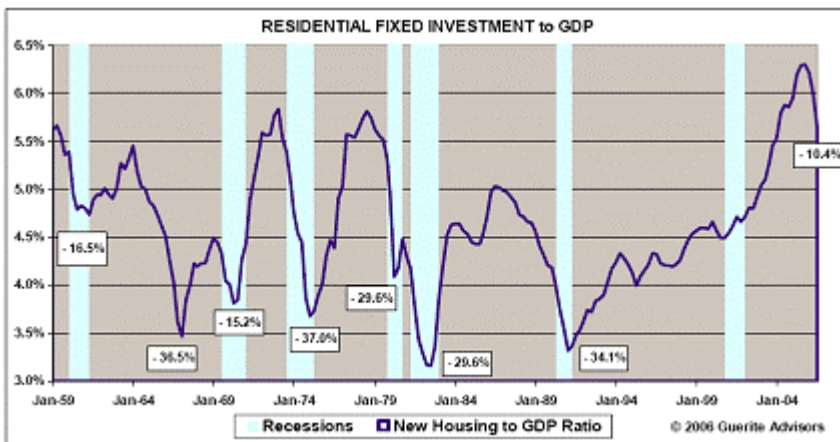
Hugh tells us that "In the previous seven cycles since 1959, housing starts (seasonally adjusted) have fallen, on average, 50.7% from peak-to-trough. Each time housing starts have fallen more than 25% from their most recent peak, a recession has followed (except during the 'credit crunch' of 1966-67 that ended in an economic contraction, but not an 'official' recession)."

1967 saw one quarter of contracting GDP, but the official NBER recessions require 2 quarters. The stock market did not like even one quarter of GDP contraction, dropping almost 20%.

Look at the chart below. Housing starts have dropped 34% so far since their peak in January of 2006. Just to get to the average drop we have another 20% or so drop in starts to go.



Now, let's revisit a chart I used a few weeks back. That is the ratio of residential fixed construction to GDP. In essence, Hugh is measuring how much housing construction is contributing to GDP. Every time the ratio has fallen from its peak by more than 10% we have had a recession, except in 1966, and then we had a mere "slowdown" for one quarter.



"In the seven cycles since 1959, both Housing Starts and the RFI/GDP Ratio have taken roughly 27 months, on average, to fall from peak-to-trough. As of November 2006, both indicators are 11 months (or so) past their most recent peaks...or roughly halfway to bottom."

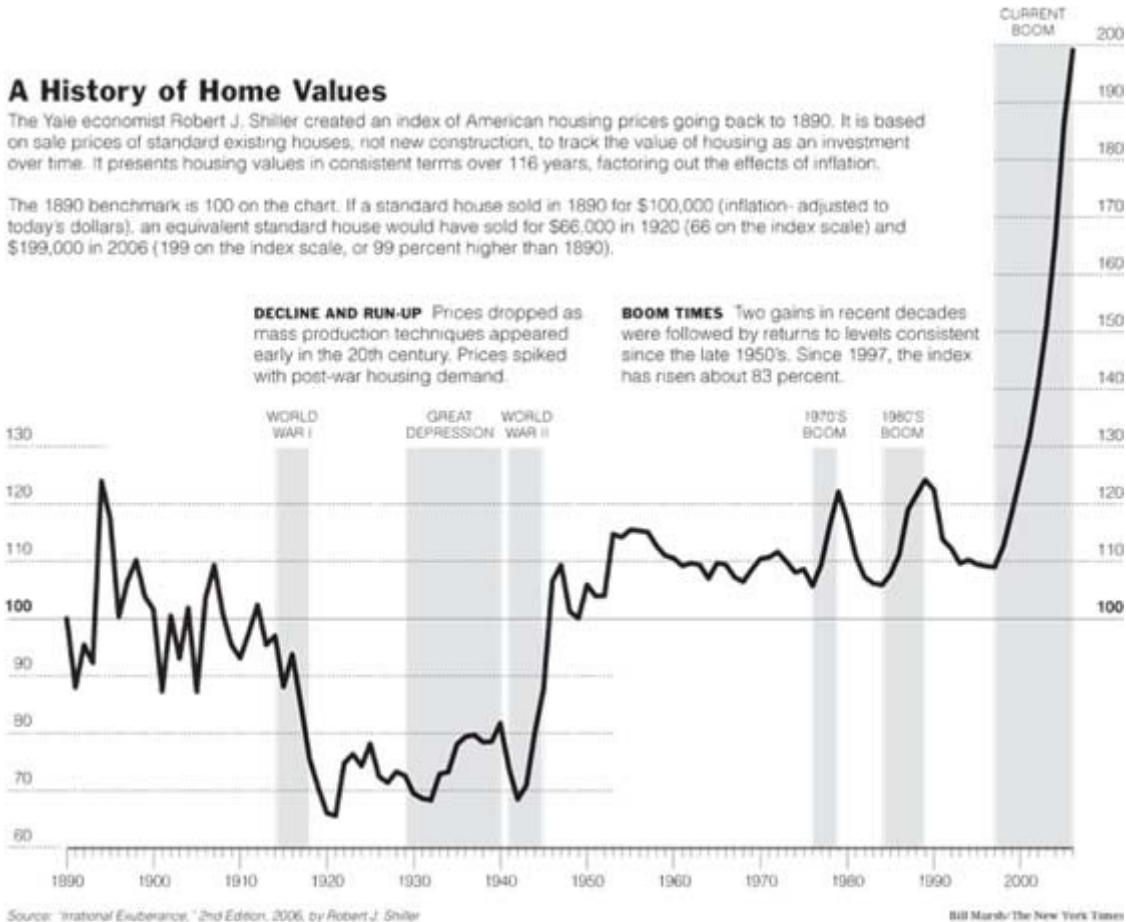
I asked Hugh to give me an estimate for this quarter for the RFI/GDP ratio. He thinks it will fall to 13.5 or so and then fall by 27% from its peak in the fourth quarter of next year. He expects residential fixed investment to drop by 20% (at least) from its peak last year, and to bottom sometime in the fourth quarter of 2007.

But Hugh may be an optimist. Look at this very interesting chart from one of my favorite analysts, Professor Robert Shiller of Yale. This chart tracks housing prices, adjusted for inflation, since 1890. This is on existing houses and not new construction. It is easy to see that the recent boom is a bubble. Since 1997, the index has risen 83%. Shiller talks about housing regressing to the mean over time. That could mean a lot more than a 20% drop in housing prices and another 12 months to the bottom. A drop to the mean could be over 40%. That is rather hard to imagine. (I hope this chart comes out ok.)

A History of Home Values

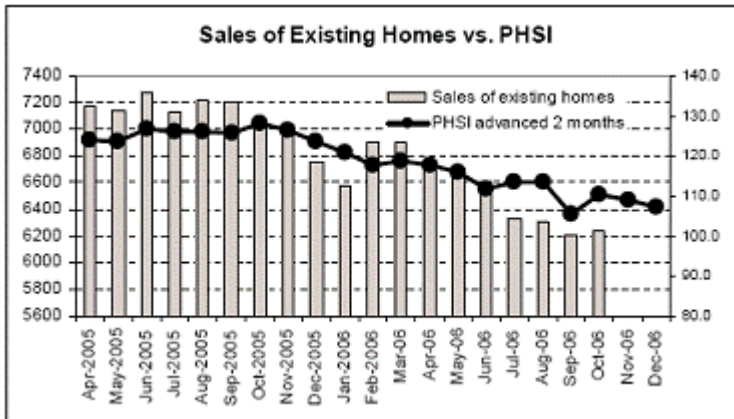
The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



Housing Sales Likely to Slow Some More

Paul Kasriel ran a rather interesting chart this week. There is something called a Pending Home Sales Index. He notes that the sales of existing homes tend to lag the PHSI by about two months. Thus the chart below would suggest that existing home sales for November and December will be down.



Housing sales and prices are the weakest on the coasts, where they went up the most. I got a letter from a rather well-off reader who has invested in rental real estate for some time and has a number of properties doing well, both from appreciation and cash flow. It is the two homes he is currently building in Florida that are giving him some problems. He has one coming to completion in a month, and he has \$240,000 in it. His realtor told him there are 100 homes in the local area like his, and they are listed for \$220,000. He has another one that will be finished in 6 months.

He has the option of renting and dealing with the negative cash flow. Not a fun thing; but for him it is an option, and that market should come back at some point, as more and more boomers will find Florida a great place to retire.

But what about all the weak hands in that market who can't deal with negative cash flow for a few months, let alone a few years? 28% of new homes started within the last year were for investment purposes. Those homes are now coming on the market. You can bet a few (at least) of those 100 homes in his neighborhood are going to be foreclosed. That means they are going to sell for less than the \$220,000 they are listed for today.

David Leonhardt, writing in the *New York Times* this week, highlights an auction for homes in Naples, Florida. On average, the homes sold for 25% less than their value in 2005. Leonhardt listed several homes that sold in 2005 and now are down 28-35% when sold at the auction. (Thanks to Barry Ritholtz for sending this to me.)

Yet the official numbers tell us that housing prices are only off by 3.1% nationwide. This just goes to show that all real estate is local. There will be areas where home prices rise next year and a lot of regions where home prices will fall very little. The national average will not reflect the real problems of areas like Naples.

"The truth is," Leonhardt writes, "that the official numbers on house prices -the last refuge of soothing information about the real estate market on the coasts -are deeply misleading. Depending on which set you look at, you'll see that prices have either continued to rise, albeit modestly, or have fallen slightly over the last year. But the statistics have a number of flaws, perhaps the biggest being that they are based only on homes that have actually sold. The numbers overlook all those homes that have been languishing on the market for months, getting only offers that their owners have not been willing to accept.

"In reality, homes across much of Florida, California and the Northeast are worth a lot less than they were a year ago. The auction in Naples may have exaggerated the downturn in the market there, but not by much. Tom Doyle, a Naples real estate agent, estimated that a typical house there, sold in the normal way, would go for about 20 percent less than it did the previous fall."

"Right now, all these [OFHEO statistical] flaws seem to be making house values look much stronger than they really are. According to the latest index, for example, the average house in Miami would have sold for 22 percent more this summer than a year earlier. You won't find many house sellers in Miami who would agree that's true.

"As Thomas Lawler, a housing economist, recently wrote in a report to clients, ***"Well, there's a growing view that this index...doesn't reflect what's really going on with home prices."***

Now, let me make the argument that it may not be as bad as in past housing recessions. When you look at the periods of serious housing declines, they are usually accompanied by serious unemployment or high interest rates. While unemployment will rise next year if we have a recession, as I think we will, we must remember that 80% of the US economy is in the service sector. It is not as in the past when the unemployment rate shot up because of lay-offs in manufacturing.

Just as housing and consumer spending, along with Bush tax cuts, deficit spending, and low interest rates, got us through the last stock market bubble with only a slight recession, corporations are in much better shape and unemployment is not likely to spike to 7-8% as it has done in the past. I think we get a mild recession.

(And yes, I understand that it a recession when your neighbor loses their job and a depression when you lose yours. Each individual situation is tough when a job is at stake, but we are talking about the national situation and not a personal one.)

Will the Dollar Continue to Fall?

I have been long-term bearish on the dollar for almost five years. But I continue to point out that even though the natural direction of the dollar is down, there will be some large moves upward. This is not a one-way trade. For that we should be grateful. We do not want a large, quick drop in the dollar. The recent move has been pretty fast. It would be nice for a reversal or at least a halt in the drop. Is one likely?

The current cover of *The Economist* highlights the falling dollar. That reminds me of a very bearish cover story by *The Economist* of December 4, 2004.



What happened after that? The dollar was 8.6% higher six months later. When these trades make the cover of major magazines, and every article in the *Financial Times* is almost uniformly bearish, it should give you pause. For the dollar to fall even more, there has to be someone on the other side of the trade. And for now, almost everyone is bearish.

It would not surprise me to see the dollar strengthen, or the fall to stop for a period of time before slowly resuming its natural downward course. Of course, good friend Addison Wiggin would see a far more dire future for the dollar. For a less sanguine view try his recent book, *The Demise of the Dollar*, at www.amazon.com. It is a cautionary tale.

The Three Irish Tenors

One of my few real regrets in life is that I did not keep up a nascent singing talent in my youth. Somehow, time got away from me, along with my voice. Like any muscle, I found that if you don't use it, you lose it. My kids now ask me to not sing and can't believe that Dad could once carry a tune.

My father was a fan of Irish tenors, and I grew up with that lilting sound haunting our home. I eventually sang with the Fort Worth Opera Chorus when I was in high school, at one time standing ten feet from Beverly Sills doing the mad scene from Lucia de Lammamoor. I was onstage with some upstart tenor from the New York Opera called Placido Domingo doing the death scene in La Traviata in head tones during the rehearsal. There were few dry eyes in the house. I have listened to Pavarotti and Bocelli live, as well as Ray Charles and the Eagles.

Few sounds have moved me as much as a Vietnamese choir singing at the funeral of a young friend who tragically died of an infection after she had beaten leukemia. It was the most heartrending sound I have ever heard. Barbershop quartets, madrigals, choirs, and musicals were all part of my life. I was even briefly a choir director at a church while in school.

Knowing of my love of Irish tenors in my younger days, this last week my "baby" sister asked if I wanted to go to a concert by a group called the Three Irish Tenors. She somehow got us front row seats at Bass Hall. I fell in love all over again.

Maybe it is the Irish blood in me (Kelly and Muldoon) that creates the connection, but I noticed that there was a large diversity in the hall that night, and all were held under the sway of The Three Irish Tenors. While a Pavarotti or Domingo has more sheer power, for pulling at your emotional heartstrings a great Irish tenor is their equal. There is just something about Irish music that moves you, whether their sad ballads or their jigs. If you get to go to one of their concerts or listen to them on PBS, you should. <http://www.theirishtenors.info/index.htm>

Tomorrow night will be a rare treat for me. I have just two season tickets for the Dallas Mavericks, so if I take one of the kids, it is just one of them and me. The publisher of this letter, Mike Casson, has given me an additional six seats (near mine as it turns out), so I get to take more of the kids and their significant others and wives, as well as my youngest son Trey (who is 12). It will be great fun! Now if the Mavs can just beat the Nuggets as well! Oh, yeah, and there is that other Dallas team playing on Sunday night. They are starting to impress me, and the town has gone crazy over Romo. If he wins tomorrow night, we may start seeing a bubble in Dallas sports futures.

I hope you are enjoying your holidays. This is a great time of the year. We will put the tree up tomorrow, and the house will become more festive. Have yourself a great week,

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